



[Docket No. OP-1779]

## **Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts**

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Proposed policy statement with request for comment.

**SUMMARY:** The Board of Governors of the Federal Reserve System (Board) is inviting comment on a proposed policy statement for prudent commercial real estate loan accommodations and workouts (proposed statement), which would be relevant to all financial institutions supervised by the Board. The proposed statement was developed jointly by the Board, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA) in consultation with state bank and credit union regulators and is identical in content to the proposal issued by the OCC, FDIC, and NCUA on August 2, 2022. The proposed statement would build on existing guidance on the need for financial institutions to work prudently and constructively with creditworthy borrowers during times of financial stress, update existing interagency guidance on commercial real estate loan workouts, and add a new section on short-term loan accommodations. The proposed statement would also address recent accounting changes on estimating loan losses and provide updated examples of how to classify and account for loans subject to loan accommodations or loan workout activity. The proposed statement is timely in the post-pandemic era, as trends such as increased remote working may shift historic patterns of demand for commercial real estate in ways that adversely affect the financial condition and repayment capacity of CRE borrowers.

**DATES:** Comments must be received by [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

**ADDRESSES:** Interested parties are encouraged to submit written comments.

Comments should be directed to:

- **Agency Website:** <http://www.federalreserve.gov>. Follow the instructions for submitting comments [https://www.federalreserve.gov/foia/about\\_foia.htm](https://www.federalreserve.gov/foia/about_foia.htm), choose “Proposals for Comment”.
- **E-mail:** [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include the docket number in the subject line of the message.
- **FAX:** (202) 452-3819 or (202) 452-3102.
- **Mail:** Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

*Instructions:* All public comments are available from the Board’s website at <https://www.federalreserve.gov/foia/readingrooms.htm> as submitted. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room M-4365A, 2001 C Street, NW, Washington, DC 20551, between 9:00 a.m. and 5:00 p.m. during Federal business weekdays. For security reasons, the Board requires that visitors make an appointment to inspect comments by calling (202) 452-3684. Upon arrival, visitors will be required to present valid government-issued photo identification and to submit to security screening in order to inspect and photocopy comments. For users of TTY-TRS, please call 711 from any telephone, anywhere in the United States.

**FOR FURTHER INFORMATION CONTACT:** Juan Climent, Assistant Director, (202) 872-7526; Kathryn Ballintine, Manager, (202) 452-2555; Carmen Holly, Lead Financial Institution Policy Analyst, (202) 973-6122; Ryan Engler, Senior Financial Institution Policy Analyst I, (202) 452-2050; Kevin Chiu, Senior Accounting Policy Analyst, (202) 912-4608, the Division of Supervision and Regulation; Jay Schwarz, Assistant General Counsel, (202) 452-2970; Gillian Burgess, Senior Counsel, (202) 736-5564, Legal Division, Board of

Governors of the Federal Reserve System, 20th and C Streets NW, Washington, DC 20551.

For users of TTY-TRS, please call 711 from any telephone, anywhere in the United States.

## **SUPPLEMENTARY INFORMATION:**

### **I. Background**

On October 30, 2009, the Board, along with the OCC, FDIC, NCUA, Federal Financial Institutions Examination Council (FFIEC) State Liaison Committee, and the former Office of Thrift Supervision, adopted the Policy Statement on Prudent Commercial Real Estate Loan Workouts, which was issued by the FFIEC (2009 statement).<sup>1</sup> The Board views the 2009 statement as being useful for both agency staff and financial institutions in understanding risk management and accounting practices for commercial real estate (CRE) loan workouts.

The Board is proposing to update and expand the 2009 statement by incorporating recent policy guidance on loan accommodations and accounting developments for estimating loan losses. The Board developed the proposed statement with the OCC, FDIC, and NCUA and consulted with state bank and credit union regulators. If finalized, the proposed statement would supersede the 2009 statement for all supervised financial institutions.<sup>2</sup>

### **II. Overview of the Proposed Statement**

The proposed statement discusses the importance of working constructively with CRE borrowers who are experiencing financial difficulty and would be appropriate for all supervised financial institutions engaged in CRE lending that apply U.S. generally accepted accounting principles (GAAP). The proposed statement addresses supervisory expectations with respect to a financial institution's handling of loan accommodations and loan workouts on matters including (1) risk management elements, (2) classification of loans, (3) regulatory reporting, and (4) accounting considerations. While focused on CRE loans, the proposed

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<sup>1</sup> See *FFIEC Press Release, October 30, 2009*, available at: <https://www.ffiec.gov/press/pr103009.htm>; See Federal Reserve Supervision and Regulation (SR) letter 09-7 (October 30, 2009).

<sup>2</sup> For purposes of this guidance, financial institutions are those supervised by the Board.

statement includes general principles that are relevant to a financial institution's commercial loans that are collateralized by either real property or other business assets (e.g., furniture, fixtures, or equipment) of a borrower. Additionally, the proposed statement would include updated references to supervisory guidance<sup>3</sup> and would revise language to incorporate current industry terminology.

Prudent CRE loan accommodations and workouts are often in the best interest of both the financial institution and the borrower. As such, and consistent with safety and soundness standards, the proposed statement reaffirms two key principles from the 2009 statement: (1) financial institutions that implement prudent CRE loan accommodation and workout arrangements after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for engaging in these efforts, even if these arrangements result in modified loans that have weaknesses that result in adverse credit classification; and (2) modified loans to borrowers who have the ability to repay their debts according to reasonable terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.

The proposed statement includes the following changes: (1) a new section on short-term loan accommodations; (2) information about recent changes in accounting principles; and (3) revisions and additions to examples of CRE loan workouts.

#### *Short-Term Loan Accommodations*

The Board recognizes that financial institutions may benefit from the proposed statement's inclusion of a discussion on the use of short-term and less complex CRE loan accommodations before a loan requires a longer term or more complex workout scenario.

The proposed statement would identify short-term loan accommodations as a tool that can be used to mitigate adverse effects on borrowers and would encourage financial institutions to

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<sup>3</sup> Supervisory guidance outlines the Board's supervisory practices or priorities and articulates the Board's general views regarding appropriate practices for a given subject area. The Board has adopted regulation setting forth Statements Clarifying the Role of Supervisory Guidance. See 12 CFR 262, appendix A.

work prudently with borrowers who are or may be unable to meet their contractual payment obligations during periods of financial stress. This section of the proposed statement would incorporate principles consistent with existing interagency guidance on accommodations.<sup>4</sup>

### *Accounting Changes*

The proposed statement also would reflect changes in GAAP since 2009, including those in relation to current expected credit losses (CECL).<sup>5</sup> The discussion would align with existing regulatory reporting guidance and instructions that have also been updated to reflect current accounting requirements under GAAP.<sup>6</sup> In particular, the section for Regulatory Reporting and Accounting Considerations would be modified to include CECL references. Appendices 5 and 6 of the proposed statement would address the relevant accounting and regulatory guidance on estimating loan losses for financial institutions that use the CECL methodology, or incurred loss methodology, respectively.

The Board also notes that the Financial Accounting Standards Board (FASB) has issued ASU 2022-02, “Financial Instruments - Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures,” which amended ASC Topic 326, Financial Instruments – Credit Losses. Once adopted, ASU 2022-02 will eliminate the need for financial institutions to identify and account for loan modifications as troubled debt restructuring (TDR) and will enhance disclosure requirements for certain modifications by creditors when a borrower is experiencing financial difficulty.<sup>7</sup> The Board plans to remove the TDR determination from the examples once all financial institutions are required to

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<sup>4</sup> See *Joint Statement on Additional Loan Accommodations Related to COVID-19*. SR Letter 20-18. See also *Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working With Customers Affected by the Coronavirus (Revised)*; Joint Press Release April 7, 2020.

<sup>5</sup> The Financial Accounting Standards Board’s (FASB’s) Accounting Standards Update 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* and subsequent amendments issued since June 2016 are codified in Accounting Standards Codification (ASC) Topic 326, *Financial Instruments – Credit Losses* (FASB ASC Topic 326). FASB ASC Topic 326 revises the accounting for the allowances for credit losses (ACLs) and introduces CECL.

<sup>6</sup> For FDIC-insured depository institutions, the FFIEC Consolidated Reports of Condition and Income (FFIEC Call Report).

<sup>7</sup> Financial institutions may only early adopt ASU 2022-02 if ASC Topic 326 is adopted. Financial institutions that have not adopted ASC Topic 326 will continue to report TDRs and will only report in accordance with ASU 2022-02 concurrently with the adoption of ASC Topic 326.

report in accordance with ASU 2022-02 and ASC Topic 326 by year-end 2023. In the interim, the Board has modified sections of the proposed statement to reflect recent updates that have occurred pertaining to TDR accounting for financial institutions that are still required to report TDRs.

#### *CRE Workout Examples*

The proposed statement would include updated information about current industry loan workout practices and revisions to examples of CRE loan workouts. The examples in the proposed statement are intended to illustrate the application of existing guidance on (1) credit classification, (2) determination of nonaccrual status, and (3) determination of TDR status. The proposed statement also would revise the 2009 statement to provide Appendix 2, which contains an updated summary of selected references to relevant supervisory guidance and accounting standards for real estate lending, appraisals, restructured loans, fair value measurement, and regulatory reporting matters such as a loan's nonaccrual status.

The proposed statement would retain information in Appendix 3 about valuation concepts for income-producing real property included in the 2009 statement. Further, Appendix 4 of the proposed statement restates the Board's long-standing special mention and classification definitions that are referenced and applied in the examples in Appendix 1.

The proposed statement would be consistent with the *Interagency Guidelines Establishing Standards for Safety and Soundness* issued by the Board,<sup>8</sup> which articulates safety and soundness standards for insured depository institutions to establish and maintain prudent credit underwriting practices and to establish and maintain systems to identify problem assets and manage deterioration in those assets commensurate with a financial institution's size and the nature and scope of its operations.

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<sup>8</sup> 12 CFR part 208 appendix D-1.

### **III. Request for Comment**

The Board requests comments on all aspects of the proposed statement and responses to the questions set forth below:

*Question 1: To what extent does the proposed statement reflect safe and sound practices currently incorporated in a financial institution's CRE loan accommodation and workout activities? Should the Board add, modify, or remove any elements, and, if so, which and why?*

*Question 2: What additional information, if any, should be included to optimize the guidance for managing CRE loan portfolios during all business cycles and why?*

*Question 3: Some of the principles discussed in the proposed statement are appropriate for Commercial & Industrial (C&I) lending secured by personal property or other business assets. Should the Board further address C&I lending more explicitly, and if so, how?*

*Question 4: What additional loan workout examples or scenarios should the Board include or discuss? Are there examples in Appendix 1 of the proposed statement that are not needed, and if so, why not? Should any of the examples in the proposed statement be revised to better reflect current practices, and if so, how?*

*Question 5: To what extent do the TDR examples continue to be relevant in 2023 given that ASU 2022-02 eliminates the need for a financial institution to identify and account for a new loan modification as a TDR?*

### **IV. Paperwork Reduction Act**

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3521) states that no agency may conduct or sponsor, nor is the respondent required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The Board has determined that this proposed policy statement does not create any new, or revise any existing, collections of information pursuant to the Paperwork Reduction Act. Consequently, no information collection request will be submitted to the OMB for review.

## V. Proposed Guidance

The text of the proposed Statement is as follows:

### **Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts**

The Board of Governors of the Federal Reserve System (Board) recognizes that financial institutions<sup>1</sup> face significant challenges when working with commercial real estate (CRE)<sup>2</sup> borrowers who are experiencing diminished operating cash flows, depreciated collateral values, prolonged sales and rental absorption periods, or other issues that may hinder repayment. While borrowers may experience deterioration in their financial condition, many continue to be creditworthy and have the willingness and capacity to repay their debts. In such cases, financial institutions may find it beneficial to work constructively with borrowers. Such constructive efforts may involve loan accommodations<sup>3</sup> or more extensive loan workout arrangements.<sup>4</sup>

This statement provides a broad set of principles relevant to CRE loan accommodations and workouts in all business cycles, particularly in challenging economic environments. A variety of factors can drive challenging economic environments, including economic downturns, natural disasters, and local, national, and international events. This statement also describes how examiners will review CRE loan accommodation and workout arrangements and provides examples of CRE workout arrangements as well as useful references in the appendices.

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<sup>1</sup> For the purposes of this statement, financial institutions are those supervised by the Board.

<sup>2</sup> Consistent with the Board, FDIC and OCC joint guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (December 2006), CRE loans include loans secured by multifamily property, and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. CRE loans also include land development and construction loans (including 1- to 4-family residential and commercial construction loans), other land loans, loans to real estate investment trusts (REITs), and unsecured loans to developers.

<sup>3</sup> For the purposes of this statement, an accommodation includes any agreement to defer one or more payments, make a partial payment, forbear any delinquent amounts, modify a loan or contract or provide other assistance or relief to a borrower who is experiencing a financial challenge.

<sup>4</sup> Workouts can take many forms, including a renewal or extension of loan terms, extension of additional credit, or a restructuring with or without concessions.



The Board has found that prudent CRE loan accommodations and workouts are often in the best interest of the financial institution and the borrower. Examiners are expected to take a balanced approach in assessing the adequacy of a financial institution's risk management practices for loan accommodation and workout activities. Consistent with the *Interagency Guidelines Establishing Standards for Safety and Soundness*,<sup>5</sup> (safety and soundness standards), financial institutions that implement prudent CRE loan accommodation and workout arrangements after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for engaging in these efforts, even if these arrangements result in modified loans that have weaknesses that result in adverse classification. In addition, modified loans to borrowers who have the ability to repay their debts according to reasonable terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the outstanding loan balance.

## **I. Purpose**

Consistent with the safety and soundness standards, this statement updates and supersedes existing supervisory guidance to assist financial institutions' efforts to modify CRE loans to borrowers who are, or may be, unable to meet a loan's current contractual payment obligations or fully repay the debt.<sup>6</sup> This statement is intended to promote supervisory consistency among examiners, enhance the transparency of CRE loan accommodation and workout arrangements, and ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound borrowers.

This statement addresses prudent risk management practices regarding short-term accommodations, risk management elements for loan workout programs, long-term loan workout arrangements, classification of loans, and regulatory reporting and accounting

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<sup>5</sup> See 12 CFR part 208 appendix D-1.

<sup>6</sup> This statement replaces the interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* (October 2009).

requirements and considerations. The statement also includes selected references and materials related to regulatory reporting.<sup>7</sup> The statement does not, however, affect existing regulatory reporting requirements or guidance provided in relevant interagency statements issued by the Board or accounting requirements under U.S. generally accepted accounting principles (GAAP). Certain principles in this statement are also generally applicable to commercial loans that are secured by either real property or other business assets of a commercial borrower.

Six appendices are incorporated into this statement:

- Appendix 1 contains examples of CRE loan workout arrangements illustrating the application of this statement to classification of loans, and determination of accrual treatment.
- Appendix 2 lists selected relevant rules as well as supervisory and accounting guidance for real estate lending, appraisals, allowance methodologies,<sup>8</sup> restructured loans, fair value measurement, and regulatory reporting matters such as nonaccrual status. This statement is intended to be used in conjunction with materials identified in Appendix 2 to reach appropriate conclusions regarding loan classification and regulatory reporting.
- Appendix 3 discusses valuation concepts for income-producing real property.<sup>9</sup>
- Appendix 4 provides the classification definitions used by the Board.
- Appendices 5 and 6 address the relevant accounting and supervisory guidance on estimating loan losses for financial institutions that use the current expected credit losses (CECL) methodology, or incurred loss methodology, respectively.

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<sup>7</sup> For banks, the FFIEC Consolidated Reports of Condition and Income (FFIEC Call Report).

<sup>8</sup> The allowance methodology refers to the allowance for credit losses (ACL) under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 326, *Financial Instruments – Credit Losses*; or allowance for loan and lease losses (ALLL) under ASC 310, *Receivables* and ASC Subtopic 450-20, *Contingencies – Loss Contingencies*, as applicable.

<sup>9</sup> Valuation concepts applied to regulatory reporting processes also should be consistent with ASC Topic 820, *Fair Value Measurement*.

## **II. Short-Term Loan Accommodations**

The Board encourages financial institutions to work prudently with borrowers who are, or may be, unable to meet their contractual payment obligations during periods of financial stress. Such actions may entail loan accommodations that are generally short-term or temporary in nature but occur before a loan reaches a workout scenario. These actions can mitigate long-term adverse effects on borrowers by allowing them to address the issues affecting repayment capacity and are often in the best interest of financial institutions and their borrowers.

When entering into an accommodation with a borrower, it is prudent for the financial institution to provide clear, accurate, and timely information about the arrangement to the borrower and any guarantor. Any such accommodation must be consistent with applicable laws and regulations. Further, a financial institution should employ prudent risk management practices and appropriate internal controls over such accommodations. Failed or imprudent risk management practices and internal controls can adversely affect borrowers, and expose a financial institution to increases in credit, compliance, operational, or other risks. Imprudent practices that are widespread at a financial institution may also pose risk to its capital adequacy.

Prudent risk management practices and internal controls will enable financial institutions to identify, measure, monitor, and manage the credit risk of accommodated loans. Prudent risk management practices include developing appropriate policies and procedures, updating and assessing financial and collateral information, maintaining appropriate risk grading, and ensuring proper tracking and accounting for loan accommodations. Prudent internal controls related to loan accommodations include comprehensive policies and practices, proper management approvals, and timely and accurate reporting and communication.

## **III. Loan Workout Programs**

When short-term accommodation measures are not sufficient or have not been successful to address credit problems, the financial institutions could proceed into longer-term or more complex loan arrangements with borrowers under a formal workout program. Loan workout arrangements can take many forms, including, but not limited to:

- Renewing or extending loan terms;
- Granting additional credit to improve prospects for overall repayment; or
- Restructuring<sup>10</sup> with or without concessions.

A financial institution's risk management practices for implementing workout arrangements should be appropriate for the scope, complexity, and nature of the financial institution's lending activity. Further, these practices should be consistent with safe-and-sound lending policies and guidance, real estate lending standards,<sup>11</sup> and relevant regulatory reporting requirements. Examiners will evaluate the effectiveness of practices, which typically address:

- A prudent workout policy that establishes appropriate loan terms and amortization schedules and that permits the financial institution to reasonably adjust the workout plan if sustained repayment performance is not demonstrated or if collateral values do not stabilize;
- Management infrastructure to identify, measure, and monitor the volume and complexity of workout activity;
- Documentation standards to verify a borrower's creditworthiness, including financial condition, repayment capacity, and collateral values;
- Management information systems and internal controls to identify and track loan performance and risk, including impact on concentration risk and the allowance;
- Processes designed to ensure that the financial institution's regulatory reports are

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<sup>10</sup> A restructuring involves a formal, legally enforceable modification in the loan's terms.

<sup>11</sup> See 12 CFR § 208.51 and part 208, appendix C.

consistent with regulatory reporting requirements;

- Loan collection procedures;
- Adherence to statutory, regulatory, and internal lending limits;
- Collateral administration to ensure proper lien perfection of the financial institution's collateral interests for both real and personal property; and
- An ongoing credit risk review function.

#### **IV. Long-Term Loan Workout Arrangements**

An effective loan workout arrangement should improve the lender's prospects for repayment of principal and interest, be consistent with sound banking and accounting practices, and comply with applicable laws and regulations. Typically, financial institutions consider loan workout arrangements after analyzing a borrower's repayment capacity, evaluating the support provided by guarantors, and assessing the value of any collateral pledged.

Consistent with safety and soundness standards, while loans in workout arrangements may be adversely classified, a financial institution will not be criticized for engaging in loan workout arrangements so long as management has:

- For each loan, developed a well-conceived and prudent workout plan that supports the ultimate collection of principal and interest and that is based on key elements such as:
  - Updated and comprehensive financial information on the borrower, real estate project, and all guarantors and sponsors;
  - Current valuations of the collateral supporting the loan and the workout plan;
  - Appropriate loan structure (e.g., term and amortization schedule), covenants, and requirements for curtailment or re-margining; and
  - Appropriate legal analyses and agreements, including those for changes to

loan terms;

- Analyzed the borrower's global debt<sup>12</sup> service coverage that reflects a realistic projection of the borrower's available cash flow;
- Analyzed the available cash flow of guarantors;
- Demonstrated the willingness and ability to monitor the ongoing performance of the borrower and guarantor under the terms of the workout arrangement;
- Maintained an internal risk rating or loan grading system that accurately and consistently reflects the risk in the workout arrangement; and
- Maintained an allowance methodology that calculates (or measures) an allowance in accordance with GAAP for loans that have undergone a workout arrangement and recognizes loan losses in a timely manner through provision expense and enacting appropriate charge-offs.<sup>13</sup>

#### ***A. Supervisory Assessment of Repayment Capacity of Commercial Borrowers***

The primary focus of an examiner's review of a CRE loan, including binding commitments, is an assessment of the borrower's ability to repay the loan. The major factors that influence this analysis are the borrower's willingness and capacity to repay the loan under reasonable terms and the cash flow potential of the underlying collateral or business. When analyzing a commercial borrower's repayment ability, examiners should consider the following factors:

- The borrower's character, overall financial condition, resources, and payment history;
- The nature and degree of protection provided by the cash flow from business operations or the collateral on a global basis that considers the borrower's total debt obligations;

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<sup>12</sup> Global debt represents the aggregate of a borrower's or guarantor's financial obligations, including contingent obligations.

<sup>13</sup> Additionally, if applicable, financial institutions should recognize in other liabilities an allowance for estimated credit losses on off-balance sheet credit exposures related to restructured loans (*e.g.*, loan commitments) and should reverse interest accruals on loans that are deemed uncollectible.

- Market conditions that may influence repayment prospects and the cash flow potential of the business operations or underlying collateral; and
- The prospects for repayment support from guarantors.

### ***B. Supervisory Assessment of Guarantees and Sponsorships***

Examiners should review the financial attributes of guarantees and sponsorships in considering the loan classification. The presence of a legally enforceable guarantee from a financially responsible guarantor may improve the prospects for repayment of the debt obligation and may be sufficient to preclude classification or reduce the severity of classification. A financially responsible guarantor possesses the financial capacity, the demonstrated willingness, and the incentive to provide support for the loan through ongoing payments, curtailments, or re-margining.

Examiners also review the financial attributes and economic incentives of sponsors that support a loan. Even if not legally obligated, financially responsible sponsors are similar to guarantors in that they may also possess the financial capacity, the demonstrated willingness, and may have an incentive to provide support for the loan through ongoing payments, curtailments, or re-margining.

Financial institutions that have sufficient information on the guarantor's global financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) are better able to determine the guarantor's financial capacity to fulfill the obligation. An effective assessment includes consideration of whether the guarantor has the financial capacity to fulfill the total number and amount of guarantees currently extended by the guarantor. A similar analysis should be made for any material sponsors that support the loan.

Examiners should consider whether a guarantor has demonstrated the willingness to fulfill all current and previous obligations, has sufficient economic incentive, and has a significant investment in the project. An important consideration is whether any previous

performance under its guarantee(s) was voluntary or the result of legal or other actions by the lender to enforce the guarantee(s).

### ***C. Supervisory Assessment of Collateral Values***

As the primary sources of loan repayment decline, the importance of collateral value as another repayment source increases when analyzing credit risk and developing an appropriate workout plan. Examiners will analyze real estate collateral values based on the financial institution's original appraisal or evaluation, any subsequent updates, additional pertinent information (e.g., recent inspection results), and relevant market conditions. An examiner will assess the major facts, assumptions, and valuation approaches in the collateral valuation and their influence in the financial institution's credit and allowance analyses.

The Board's appraisal regulations require financial institutions to review appraisals for compliance with the Uniform Standards of Professional Appraisal Practice.<sup>14</sup> As part of that process, and when reviewing evaluations, financial institutions should ensure that assumptions and conclusions used are reasonable. Further, financial institutions typically have policies<sup>15</sup> and procedures that dictate when collateral valuations should be updated as part of their ongoing credit monitoring processes, as market conditions change, or as a borrower's financial condition deteriorates.<sup>16</sup>

CRE loans in workout arrangements consider current project plans and market conditions in a new or updated appraisal or evaluation, as appropriate. In determining whether to obtain a new appraisal or evaluation, a prudent financial institution considers whether there has been material deterioration in the following factors: the performance of the project; conditions for the geographic market and property type; variances between actual conditions and original appraisal assumptions; changes in project specifications (e.g.,

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<sup>14</sup> See 12 CFR part 208, subpart E, and 12 CFR part 225, subpart G.

<sup>15</sup> See 12 CFR part 208.51(a).

<sup>16</sup> For further reference, see *Interagency Appraisal and Evaluation Guidelines*, 75 FR 77450 (December 10, 2010).



changing a planned condominium project to an apartment building); loss of a significant lease or a take-out commitment; or increases in pre-sale fallout. A new appraisal may not be necessary when an evaluation prepared by the financial institution appropriately updates the original appraisal assumptions to reflect current market conditions and provides a reasonable estimate of the collateral's fair value.<sup>17</sup> If new money is advanced, financial institutions should refer to the Federal financial institution supervisory agencies' appraisal regulations to determine whether a new appraisal is required.<sup>18</sup>

The market value provided by an appraisal and the fair value for accounting purposes are based on similar valuation concepts.<sup>19</sup> The analysis of the collateral's market value reflects the financial institution's understanding of the property's current "as is" condition (considering the property's highest and best use) and other relevant risk factors affecting value. Valuations of commercial properties may contain more than one value conclusion and could include an "as is" market value, a prospective "as complete" market value, and a prospective "as stabilized" market value.

Financial institutions typically use the market value conclusion (and not the fair value) that corresponds to the workout plan objective and the loan commitment. For example, if the financial institution intends to work with the borrower so that a project will achieve stabilized occupancy, then the financial institution can consider the "as stabilized" market value in its collateral assessment for credit risk grading after confirming that the appraisal's assumptions and conclusions are reasonable. Conversely, if the financial institution intends to foreclose,

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<sup>17</sup> According to the FASB ASC Master Glossary, "fair value" is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

<sup>18</sup> See footnote 18.

<sup>19</sup> The term "market value" as used in an appraisal is based on similar valuation concepts as "fair value" for accounting purposes under GAAP. For both terms, these valuation concepts about the real property and the real estate transaction contemplate that the property has been exposed to the market before the valuation date, the buyer and seller are well informed and acting in their own best interest (that is, the transaction is not a forced liquidation or distressed sale), and marketing activities are usual and customary (that is, the value of the property is unaffected by special financing or sales concessions). The market value in an appraisal may differ from the collateral's fair value if the values are determined as of different dates or the fair value estimate reflects different assumptions from those in the appraisal. This may occur as a result of changes in market conditions and property use since the "as of" date of the appraisal.

then it is more appropriate for the financial institution to use the fair value (less costs to sell)<sup>20</sup> of the property in its current “as is” condition in its collateral assessment.

If weaknesses are noted in the financial institution’s supporting documentation or appraisal or evaluation review process, examiners should direct the financial institution to address the weaknesses, which may require the financial institution to obtain a new collateral valuation. However, if the financial institution is unable or unwilling to address deficiencies in a timely manner, examiners will have to assess the degree of protection that the collateral affords when analyzing and classifying the loan. In performing this assessment of collateral support, examiners may adjust the collateral’s value to reflect current market conditions and events. When reviewing the reasonableness of the facts and assumptions associated with the value of an income-producing property, examiners evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Effective rental rates or sale prices, considering sales and financing concessions;
- Time frame for achieving stabilized occupancy or sellout;
- Volume and trends in past due leases;
- Net operating income of the property as compared with budget projections, reflecting reasonable operating and maintenance costs; and
- Discount rates and direct capitalization rates (refer to Appendix 3 for more information).

Assumptions, when recently made by qualified appraisers (and, as appropriate, by the financial institution) and when consistent with the discussion above, should be given reasonable deference by examiners. Examiners should also use the appropriate market value conclusion in their collateral assessments. For example, when the financial institution plans

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<sup>20</sup> Costs to sell are used when the loan is dependent on the sale of the collateral. Costs to sell are not used when the collateral-dependent loan is dependent on the operation of the collateral.

to provide the resources to complete a project, examiners can consider the project's prospective market value and the committed loan amount in their analysis.

Examiners generally are not expected to challenge the underlying assumptions, including discount rates and capitalization rates, used in appraisals or evaluations when these assumptions differ only marginally from norms generally associated with the collateral under review. The estimated value of the collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate and when the examiner can support alternative assumptions.

Many CRE borrowers may have their commercial loans secured by owner occupied real estate or other business assets, such as inventory and accounts receivable, or may have CRE loans also secured by furniture, fixtures, and equipment. For these loans, the financial institution should have appropriate policies and practices for quantifying the value of such collateral, determining the acceptability of the assets as collateral, and perfecting its security interests. The financial institution also should have appropriate procedures for ongoing monitoring of this type of collateral and the financial institution's interests and security protection.

## **V. Classification of Loans**

Loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not adversely classified. Similarly, loans to sound borrowers that are modified in accordance with prudent underwriting standards should not be adversely classified unless well-defined weaknesses exist that jeopardize repayment. However, such loans could be flagged for management's attention or other designated "watch lists" of loans that management is more closely monitoring.

Further, examiners should not adversely classify loans solely because the borrower is associated with a particular industry that is experiencing financial difficulties. When a

financial institution's loan modifications are not supported by adequate analysis and documentation, examiners are expected to exercise reasonable judgment in reviewing and determining loan classifications until such time as the financial institution is able to provide information to support management's conclusions and internal loan grades. Refer to Appendix 4 for the classification definitions.

***A. Loan Performance Assessment for Classification Purposes***

The loan's record of performance to date should be one of several considerations when determining whether a loan should be adversely classified. As a general principle, examiners should not adversely classify or require the recognition of a partial charge-off on a performing commercial loan solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it is appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment.

One perspective of loan performance is based upon an assessment as to whether the borrower is contractually current on principal or interest payments. For many loans, this definition is sufficient and accurately portrays the status of the loan. In other cases, being contractually current on payments can be misleading as to the credit risk embedded in the loan. This may occur when the loan's underwriting structure or the liberal use of extensions and renewals masks credit weaknesses and obscures a borrower's inability to meet reasonable repayment terms.

For example, for many acquisition, development, and construction projects, the loan is structured with an "interest reserve" for the construction phase of the project. At the time the loan is originated, the lender establishes the interest reserve as a portion of the initial loan commitment. During the construction phase, the lender recognizes interest income from the interest reserve and capitalizes the interest into the loan balance. After completion of the construction, the lender recognizes the proceeds from the sale of lots, homes, or buildings for the repayment of principal, including any of the capitalized interest. For a commercial

construction loan where the property has achieved stabilized occupancy, the lender uses the proceeds from permanent financing for repayment of the construction loan or converts the construction loan to an amortizing loan.

However, if the development project stalls and management fails to evaluate the collectability of the loan, interest income may continue to be recognized from the interest reserve and capitalized into the loan balance, even though the project is not generating sufficient cash flows to repay the loan. In such cases, the loan will be contractually current due to the interest payments being funded from the reserve, but the repayment of principal may be in jeopardy, especially when leases or sales have not occurred as projected and property values have dropped below the market value reported in the original collateral valuation. In these situations, adverse classification of the loan may be appropriate.

A second perspective for assessing a loan's classification is to consider the borrower's expected performance and ability to meet its obligations in accordance with the modified terms over the loan's tenure. Therefore, the loan classification is meant to measure risk over the term of the loan rather than just reflecting the loan's payment history. As a borrower's expected performance is dependent upon future events, examiners' credit analyses should focus on:

- The borrower's financial strength as reflected by its historical and projected balance sheet and income statement outcomes; and
- The prospects for a CRE property in light of events and market conditions that reasonably may occur during the term of the loan.

### ***B. Classification of Renewals or Restructurings of Maturing Loans***

Loans to commercial borrowers can have short maturities, including short-term working capital loans to businesses, financing for CRE construction projects, or loans to finance recently completed CRE projects for the period to achieve stabilized occupancy.

When there has been deterioration in collateral values, a borrower with a maturing loan amid

an economic downturn may have difficulty obtaining short-term financing or adequate sources of long-term credit, despite their demonstrated and continued ability to service the debt. In such cases, financial institutions may determine that the most appropriate course is to restructure or renew the loans. Such actions, when done prudently, are often in the best interest of both the financial institution and the borrower.

A restructured loan typically reflects an elevated level of credit risk, as the borrower may not be, or has not been, able to perform according to the original contractual terms. The assessment of each loan should be based upon the fundamental characteristics affecting the collectability of that loan. In general, renewals or restructurings of maturing loans to commercial borrowers who have the ability to repay on reasonable terms will not automatically be subject to adverse classification by examiners. However, consistent with safety and soundness standards, such loans are identified in the financial institution's internal credit grading system and may warrant close monitoring. Adverse classification of a renewed or restructured loan would be appropriate, if, despite the renewal or restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan pursuant to reasonable modified terms.

### ***C. Classification of Troubled CRE Loans Dependent on the Sale of Collateral for Repayment***

As a general classification principle for a troubled CRE loan that is dependent on the sale of the collateral for repayment, any portion of the loan balance that exceeds the amount that is adequately secured by the fair value of the real estate collateral less the costs to sell should be classified "loss." This principle applies to loans that are collateral dependent based on the sale of the collateral in accordance with GAAP and there are no other available reliable sources of repayment such as a financially capable guarantor.<sup>21</sup>

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<sup>21</sup> Under ASC Topic 310, applicable for financial institutions reporting an ALLL, a loan is collateral dependent if repayment of the loan is expected to be provided solely by sale or operation of the collateral. Under ASC Topic 326, applicable for financial institutions reporting an ACL, a loan is collateral dependent when the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date.

The portion of the loan balance that is adequately secured by the fair value of the real estate collateral less the costs to sell generally should be adversely classified no worse than “substandard.” The amount of the loan balance in excess of the fair value of the real estate collateral, or portions thereof, should be adversely classified “doubtful” when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined. If warranted by the underlying circumstances, an examiner may use a “doubtful” classification on the entire loan balance. However, examiners should use a “doubtful” classification infrequently and for a limited time period to permit the pending events to be resolved.

***D. Classification and Accrual Treatment of Restructured Loans with a Partial Charge-off***

Based on consideration of all relevant factors, an assessment may indicate that a loan has well-defined weaknesses that jeopardize collection in full of all amounts contractually due and may result in a partial charge-off as part of a restructuring. When well-defined weaknesses exist and a partial charge-off has been taken, the remaining recorded balance for the restructured loan generally should be classified no more severely than “substandard.” A more severe classification than “substandard” for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined. Such situations may occur where significant remaining risk exposures are identified but are not quantified, such as bankruptcy or a loan collateralized by a property with potential environmental concerns.

A restructuring may involve a multiple note structure in which, for example, a troubled loan is restructured into two notes. Lenders may separate a portion of the current outstanding debt into a new, legally enforceable note (i.e., Note A) that is reasonably assured of repayment and performance according to prudently modified terms. This note may be placed back on accrual status in certain situations. In returning the loan to accrual status, sustained historical payment performance for a reasonable time prior to the restructuring may be taken into account. Additionally, a properly structured and performing “Note A” generally

would not be adversely classified by examiners. The portion of the debt that is not reasonably assured of repayment (i.e., Note B) must be adversely classified and charged-off.

In contrast, the loan should remain on, or be placed on, nonaccrual status if the lender does not split the loan into separate notes, but internally recognizes a partial charge-off. A partial charge-off would indicate that the financial institution does not expect full repayment of the amounts contractually due. If facts change after the charge-off is taken such that the full amounts contractually due, including the amount charged off, are expected to be collected and the loan has been brought contractually current, the remaining balance of the loan may be returned to accrual status without having to first receive payment of the charged-off amount.<sup>22</sup> In these cases, examiners should assess whether the financial institution has well-documented support for its credit assessment of the borrower's financial condition and the prospects for full repayment.

## **VI. Regulatory Reporting and Accounting Considerations**

Financial institution management is responsible for preparing regulatory reports in accordance with GAAP and regulatory reporting requirements. Management also is responsible for establishing and maintaining an appropriate governance and internal control structure over the preparation of regulatory reports. The Board has observed this governance and control structure commonly includes policies and procedures that provide clear guidelines on accounting matters. Accurate regulatory reports are critical to the transparency of a financial institution's financial position and risk profile and imperative for effective supervision. Decisions related to loan workout arrangements may affect regulatory reporting, particularly interest accruals, and loan loss estimates. Therefore, it is important that loan workout staff appropriately communicate with the accounting and regulatory reporting staff

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<sup>22</sup> The charged-off amount should not be reversed or re-booked, under any condition, to increase the recorded investment in the loan or its amortized costs, as applicable, when the loan is returned to accrual status. However, expected recoveries, prior to collection, are a component of management's estimate of the net amount expected to be collected for a loan under ASC Topic 326. Refer to relevant regulatory reporting instructions for guidance on returning a loan to accrual status.



concerning the financial institution's loan restructurings and that the reporting consequences of restructurings are presented accurately in regulatory reports.

In addition to evaluating credit risk management processes and validating the accuracy of internal loan grades, examiners are responsible for reviewing management's processes related to accounting and regulatory reporting. While similar data are used for loan risk monitoring, accounting, and reporting systems, this information does not necessarily produce identical outcomes. For example, loss classifications may not be equivalent to the associated allowance measurements.

#### ***A. Allowance for Credit Losses***

Examiners need to have a clear understanding of the differences between credit risk management and accounting and regulatory reporting concepts (such as accrual status, restructurings, and the allowance) when assessing the adequacy of the financial institution's reporting practices for on- and off-balance sheet credit exposures. Refer to the appropriate Appendix that provides a summary of the allowance standards under the incurred loss methodology (Appendix 6) or the CECL methodology for institutions that have adopted ASC Topic 326, *Financial Instruments – Credit Losses* (Appendix 5). Examiners should also refer to regulatory reporting instructions in the FFIEC Call Report guidance and applicable GAAP for further information.

#### ***B. Implications for Interest Accrual***

A financial institution needs to consider whether a loan that was accruing interest prior to the loan restructuring should be placed in nonaccrual status at the time of modification to ensure that income is not materially overstated. Consistent with Call Report Instructions, a loan that has been restructured so as to be reasonably assured of repayment and performance according to prudent modified terms need not be placed in nonaccrual status. Therefore, for a loan to remain on accrual status, the restructuring and any charge-off taken on the loan have to be supported by a current, well-documented credit assessment of the borrower's financial

condition and prospects for repayment under the revised terms. Otherwise, in accordance with outstanding Call Report instructions, the restructured loan must be placed in nonaccrual status.

A restructured loan placed in nonaccrual status should not be returned to accrual status until the borrower demonstrates a period of sustained repayment performance for a reasonable period prior to the date on which the loan is returned to accrual status. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents. It may also include historical periods prior to the date of the loan restructuring. While an appropriately designed restructuring should improve the collectability of the loan in accordance with a reasonable repayment schedule, it does not relieve the financial institution from the responsibility to promptly charge off all identified losses. For more detailed instructions about placing a loan in nonaccrual status and returning a nonaccrual loan to accrual status, refer to the instructions for the FFIEC Call Report.

## Appendix 1

### Examples of CRE Loan Workout Arrangements

The examples in this Appendix are provided for illustrative purposes only and are designed to demonstrate an examiner's analytical thought process to derive an appropriate classification and evaluate implications for interest accrual and appropriate regulatory reporting, such as whether a loan should be reported as a troubled debt restructuring (TDR).<sup>23</sup> Although not discussed in the examples below, examiners consider the adequacy of a lender's supporting documentation, internal analysis, and business decision to enter into a loan workout arrangement. The examples also do not address the effect of the loan workout arrangement on the allowance and subsequent reporting requirements.

Examiners should use caution when applying these examples to "real-life" situations, consider all facts and circumstances of the loan being evaluated, and exercise judgment before reaching conclusions related to loan classifications, accrual treatment, and TDR reporting.<sup>24</sup>

The TDR determination requires consideration of all of the facts and circumstances surrounding the modification. No single factor, by itself, is determinative of whether a modification is a TDR. To make this determination, the lender assesses whether (a) the borrower is *experiencing financial difficulties* and (b) the lender has granted a *concession*. For purposes of these examples, if the borrower was not *experiencing financial difficulties*, the example does not assess whether a *concession* was granted. However, in distressed situations, lenders may make *concessions* because borrowers are *experiencing financial difficulties*. Accordingly, lenders and examiners should exercise judgment in evaluating whether a restructuring is a TDR. In addition, some examples refer to disclosures of TDRs, which pertain only to the reporting in Schedules RC-C or RC-N of the Call Report and not the

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<sup>23</sup> The Board views that the accrual treatments in these examples as falling within the range of acceptable practices under regulatory reporting instructions.

<sup>24</sup> In addition, estimates of the fair value of collateral require the use of assumptions requiring judgment and should be consistent with measurement of fair value in ASC Topic 820, *Fair Value Measurement*; see Appendix 2.

applicable measurement in determining an appropriate allowance pursuant to the accounting standards.

***A. Income Producing Property – Office Building***

**BASE CASE:** A lender originated a \$15 million loan for the purchase of an office building with monthly payments based on an amortization of 20 years and a balloon payment of \$13.6 million at the end of year five. At origination, the loan had a 75 percent loan-to-value (LTV) based on an appraisal reflecting a \$20 million market value on an “as stabilized” basis, a debt service coverage (DSC) ratio of 1.30x, and a market interest rate. The lender expected to renew the loan when the balloon payment became due at the end of year five. Due to technological advancements and a workplace culture change since the inception of the loan, many businesses switched to hybrid work-from-home arrangements to reduce longer-term costs and improve employee retention. As a result, the property’s cash flow declined as the borrower has had to grant rental concessions to either retain its existing tenants or attract new tenants, since the demand for office space has decreased.

**SCENARIO 1:** At maturity, the lender renewed the \$13.6 million loan for one year at a market interest rate that provides for the incremental risk and payments based on amortizing the principal over the remaining 15 years. The borrower had not been delinquent on prior payments and has sufficient cash flow to service the loan at the market interest rate terms with a DSC ratio of 1.12x, based on updated financial information.

A review of the leases reflects that most tenants are stable occupants, with long-term leases and sufficient cash flow to pay their rent. The major tenants have not adopted hybrid work-from-home arrangements for their employees given the nature of the businesses. A recent appraisal reported an “as stabilized” market value of \$13.3 million for the property for an LTV of 102 percent. This reflects current market conditions and the resulting decline in cash flow.

**Classification:** The lender internally graded the loan pass and is monitoring the credit.

The examiner agreed, because the borrower has the ability to continue making loan payments based on reasonable terms, despite a decline in cash flow and in the market value of the collateral.

**Nonaccrual Treatment:** The lender maintained the loan on accrual status. The borrower has demonstrated the ability to make the regularly scheduled payments and, even with the decline in the borrower's creditworthiness, cash flow appears sufficient to make these payments, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment.

**TDR Treatment:** The lender determined that the renewed loan should not be reported as a TDR. While the borrower is experiencing some financial deterioration, the borrower has sufficient cash flow to service the debt and has no record of payment default; therefore, the borrower is not *experiencing financial difficulties*. The examiner concurred with the lender's TDR treatment.

**SCENARIO 2:** At maturity, the lender renewed the \$13.6 million loan at a market interest rate that provides for the incremental risk and payments based on amortizing the principal over the remaining 15 years. The borrower had not been delinquent on prior payments. Current projections indicate the DSC ratio will not drop below 1.12x based on leases in place and letters of intent for vacant space. However, some leases are coming up for renewal, and additional rental concessions may be necessary to either retain those existing tenants or attract new tenants. The lender estimates the property's current "as stabilized" market value is \$14.5 million, which results in a 94 percent LTV, but a current valuation has not been ordered. In addition, the lender has not asked the borrower or guarantors to provide current financial statements to assess their ability to support any cash flow shortfall.

**Classification:** The lender internally graded the loan pass and is monitoring the credit.

The examiner disagreed with the internal grade and listed the credit as special mention.

While the borrower has the ability to continue to make payments based on leases currently in place and letters of intent for vacant space, there has been a declining trend in the property's revenue stream, and there is most likely a reduced collateral margin. In addition, there is potential for further deterioration in the cash flow as more leases will expire in the upcoming months, while absorption for office space in this market has slowed. Lastly, the examiner noted that the lender failed to request current financial information and to obtain an updated collateral valuation,<sup>25</sup> representing administrative weaknesses.

***Nonaccrual Treatment:*** The lender maintained the loan on accrual status. The borrower has demonstrated the ability to make regularly scheduled payments and, even with the decline in the borrower's creditworthiness, cash flow is sufficient at this time to make payments, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment.

***TDR Treatment:*** The lender determined that the renewed loan should not be reported as a TDR. While the borrower is experiencing some financial deterioration, the borrower is not *experiencing financial difficulties* as the borrower has sufficient cash flow to service the debt, and there is no history of default. The examiner concurred with the lender's TDR treatment.

**SCENARIO 3:** At maturity, the lender restructured the \$13.6 million loan on a 12-month interest-only basis at a below market interest rate. The borrower has been sporadically delinquent on prior principal and interest payments. The borrower projects a DSC ratio of 1.10x based on the restructured interest-only terms. A review of the rent roll, which was available to the lender at the time of the restructuring, reflects the majority of tenants have short-term leases, with three leases expected to expire within the next three months.

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<sup>25</sup> In relation to comments on valuations within these examples, refer to the appraisal regulations of the applicable Federal financial institution supervisory agency to determine whether there is a regulatory requirement for either an evaluation or appraisal. See footnote 18.

According to the lender, leasing has not improved since the restructuring as market conditions remain soft. Further, the borrower does not have an update as to whether the three expiring leases will renew at maturity; two of the tenants have moved to hybrid work-from-home arrangements. A recent appraisal provided a \$14.5 million “as stabilized” market value for the property, resulting in a 94 percent LTV.

***Classification:*** The lender internally graded the loan pass and is monitoring the credit.

The examiner disagreed with the internal grade and classified the loan substandard due to the borrower’s limited ability to service a below market interest rate loan on an interest-only basis, sporadic delinquencies, and an increase in the LTV based on an updated appraisal. In addition, there is lease rollover risk because three of the leases are expiring soon, which could further limit cash flow.

***Nonaccrual Treatment:*** The lender maintained the loan on accrual status due to the positive cash flow and collateral margin. The examiner did not concur with this treatment as the loan was not restructured with reasonable repayment terms, and the borrower has not demonstrated the ability to amortize the loan and has limited capacity to service a below market interest rate on an interest-only basis. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

***TDR Treatment:*** The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties* (the project’s ongoing ability to generate sufficient cash flow to service the debt is questionable as lease income is declining, loan payments have been sporadic, leases are expiring with uncertainty as to renewal or replacement, and collateral values have declined) and the lender granted a *concession* by reducing the interest rate to a below market level and deferring principal payments. The examiner concurred with the lender’s TDR treatment.

## ***B. Income Producing Property – Retail Properties***

**BASE CASE:** A lender originated a 36-month, \$10 million loan for the construction of a shopping mall. The construction period was 24 months with a 12-month lease-up period to allow the borrower time to achieve stabilized occupancy before obtaining permanent financing. The loan had an interest reserve to cover interest payments over the three-year term. At the end of the third year, there is \$10 million outstanding on the loan, as the shopping mall has been built and the interest reserve, which has been covering interest payments, has been fully drawn.

At the time of origination, the appraisal reported an “as stabilized” market value of \$13.5 million for the property. In addition, the borrower had a take-out commitment that would provide permanent financing at maturity. A condition of the take-out lender was that the shopping mall had to achieve a 75 percent occupancy level.

Due to weak economic conditions and a shift in consumer behavior to a greater reliance on e-commerce, the property only reached a 55 percent occupancy level at the end of the 12-month lease up period. As a result, the original takeout commitment became void. In addition, there has been a considerable tightening of credit for these types of loans, and the borrower has been unable to obtain permanent financing elsewhere since the loan matured. To date, the few interested lenders are demanding significant equity contributions and much higher pricing.

**SCENARIO 1:** The lender renewed the loan for an additional 12 months to provide the borrower time for higher lease-up and to obtain permanent financing. The extension was made at a market interest rate that provides for the incremental risk and is on an interest-only basis. While the property’s historical cash flow was insufficient at a 0.92x debt service ratio, recent improvements in the occupancy level now provide adequate coverage based on the interest-only payments. Recent events include the signing of several new leases with additional leases under negotiation; however, takeout financing continues to be tight in the



market.

In addition, current financial statements reflect that the builder, who personally guarantees the debt, has cash on deposit at the lender plus other unencumbered liquid assets. These assets provide sufficient cash flow to service the borrower's global debt service requirements on a principal and interest basis, if necessary, for the next 12 months. The guarantor covered the initial cash flow shortfalls from the project and provided a good faith principal curtailment of \$200,000 at renewal, reducing the loan balance to \$9.8 million. A recent appraisal on the shopping mall reports an "as is" market value of \$10 million and an "as stabilized" market value of \$11 million, resulting in LTVs of 98 percent and 89 percent, respectively.

***Classification:*** The lender internally graded the loan as a pass and is monitoring the credit. The examiner disagreed with the lender's internal loan grade and listed it as special mention. While the project continues to lease up, cash flows cover only the interest payments. The guarantor has the ability, and has demonstrated the willingness, to cover cash flow shortfalls; however, there remains considerable uncertainty surrounding the takeout financing for this type of loan.

***Nonaccrual Treatment:*** The lender maintained the loan on accrual status as the guarantor has sufficient funds to cover the borrower's global debt service requirements over the one-year period of the renewed loan. Full repayment of principal and interest is reasonably assured from the project's and guarantor's cash resources, despite a decline in the collateral margin. The examiner concurred with the lender's accrual treatment.

***TDR Treatment:*** The lender concluded that while the borrower has been affected by declining economic conditions and a shift to e-commerce, the deterioration has not led to financial difficulties. The borrower was not *experiencing financial difficulties* because the borrower and guarantor have the ability to service the renewed loan, which was underwritten at a market interest rate, plus the borrower's other obligations on a timely basis. In addition, the lender expects to collect the full amount of principal and interest

from the borrower's or guarantor's cash sources (i.e., not from interest reserves). Therefore, the lender is not treating the loan renewal as a TDR. The examiner concurred with the lender's rationale that the loan renewal is not a TDR.

**SCENARIO 2:** The lender restructured the loan on an interest-only basis at a below market interest rate for one year to provide additional time to increase the occupancy level and, thereby, enable the borrower to arrange permanent financing. The level of lease-up remains relatively unchanged at 55 percent, and the shopping mall projects a DSC ratio of 1.02x based on the preferential loan terms. At the time of the restructuring, the lender used outdated financial information, which resulted in a positive cash flow projection. However, other file documentation available at the time of the restructuring reflected that the borrower anticipates the shopping mall's revenue stream will further decline due to rent concessions, the loss of a tenant, and limited prospects for finding new tenants.

Current financial statements indicate the builder, who personally guarantees the debt, cannot cover any cash flow shortfall. The builder is highly leveraged, has limited cash or unencumbered liquid assets, and has other projects with delinquent payments. A recent appraisal on the shopping mall reports an "as is" market value of \$9 million, which results in an LTV ratio of 111 percent.

**Classification:** The lender internally classified the loan as substandard. The examiner disagreed with the internal grade and classified the amount not protected by the collateral value, \$1 million, as loss and required the lender to charge-off this amount. The examiner did not factor costs to sell into the loss classification analysis, as the current source of repayment is not reliant on the sale of the collateral. The examiner classified the remaining loan balance, based on the property's "as is" market value of \$9 million, as substandard given the borrower's uncertain repayment capacity and weak financial support.

**Nonaccrual Treatment:** The lender determined the loan did not warrant being placed in

nonaccrual status. The examiner did not concur with this treatment because the partial charge-off is indicative that full collection of principal is not anticipated, and the lender has continued exposure to additional loss due to the project's insufficient cash flow and reduced collateral margin and the guarantor's inability to provide further support. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

***TDR Treatment:*** The lender reported the restructured loan as a TDR because (a) the borrower is *experiencing financial difficulties* as evidenced by the high leverage, delinquent payments on other projects, and inability to meet the proposed exit strategy because of the inability to lease the property in a reasonable timeframe; and (b) the lender granted a *concession* as evidenced by the reduction in the interest rate to a below market interest rate. The examiner concurred with the lender's TDR treatment.

**SCENARIO 3:** The loan has become delinquent. Recent financial statements indicate the borrower and the guarantor have minimal other resources available to support this loan. The lender chose not to restructure the \$10 million loan into a new single amortizing note of \$10 million at a market interest rate because the project's projected cash flow would only provide a 0.88x DSC ratio as the borrower has been unable to lease space. A recent appraisal on the shopping mall reported an "as is" market value of \$7 million, which results in an LTV of 143 percent.

At the original loan's maturity, the lender restructured the \$10 million debt into two notes. The lender placed the first note of \$7 million (i.e., the Note A) on monthly payments that amortize the debt over 20 years at a market interest rate that provides for the incremental risk. The project's DSC ratio equals 1.20x for the \$7 million loan based on the shopping mall's projected net operating income. The lender then charged-off the \$3 million note due to the project's lack of repayment capacity and to provide reasonable collateral protection for the remaining on-book loan of \$7 million. The lender also reversed accrued but unpaid interest.

The lender placed the second note (i.e., the Note B) consisting of the charged-off principal balance of \$3 million into a 2 percent interest-only loan that resets in five years into an amortizing payment. Since the restructuring, the borrower has made payments on both loans for more than six consecutive months and an updated financial analysis shows continued ability to repay under the new terms.

**Classification:** The lender internally graded the on-book loan of \$7 million as a pass loan due to the borrower's demonstrated ability to perform under the modified terms. The examiner agreed with the lender's grade as the lender restructured the original obligation into Notes A and B, the lender charged off Note B, and the borrower has demonstrated the ability to repay Note A. Using this multiple note structure with charge-off of the Note B enables the lender to recognize interest income and limit the amount reported as a TDR in future periods.

**Nonaccrual Treatment:** The lender placed the on-book loan (Note A) of \$7 million loan in nonaccrual status at the time of the restructure. The lender later restored the \$7 million to accrual status as the borrower has the ability to repay the loan, has a record of performing at the revised terms for more than six months, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment.

Interest payments received on the off-book loan have been recorded as recoveries because full recovery of principal and interest on this loan (Note B) was not reasonably assured.

**TDR Treatment:** The lender considered both Note A and Note B as TDRs because the borrower is *experiencing financial difficulties* and the lender granted a *concession*. The lender reported the restructured on-book loan (Note A) of \$7 million as a TDR, while the second loan (Note B) was charged off. The financial difficulties are evidenced by the borrower's high leverage, delinquent payments on other projects, inability to lease the property in a reasonable timeframe, and the unlikely collectability of the charged-off loan (Note B). The concessions on Note A include extending the on-book loan beyond

expected timeframes.

The lender plans to stop disclosing the on-book loan as a TDR after the regulatory reporting defined time period expires because the loan was restructured with a market interest rate and is in compliance with its modified terms.<sup>26</sup> The examiner agreed with the lender's TDR treatment.

**SCENARIO 4:** Current financial statements indicate the borrower and the guarantor have minimal other resources available to support this loan. The lender restructured the \$10 million loan into a new single note of \$10 million at a market interest rate that provides for the incremental risk and is on an amortizing basis. The project's projected cash flow reflects a 0.88x DSC ratio as the borrower has been unable to lease space. A recent appraisal on the shopping mall reports an "as is" market value of \$9 million, which results in an LTV of 111 percent. Based on the property's current market value of \$9 million, the lender charged-off \$1 million immediately after the renewal.

**Classification:** The lender internally graded the remaining \$9 million on-book portion of the loan as a pass loan because the lender's analysis of the project's cash flow indicated a 1.05x DSC ratio when just considering the on-book balance. The examiner disagreed with the internal grade and classified the \$9 million on-book balance as substandard due to the borrower's marginal financial condition, lack of guarantor support, and uncertainty over the source of repayment. The DSC ratio remains at 0.88x due to the single note restructure, and other resources are scant.

**Nonaccrual Treatment:** The lender maintained the remaining \$9 million on-book portion of the loan on accrual, as the borrower has the ability to repay the principal and interest on this balance. The examiner did not concur with this treatment. Because the lender restructured the debt into a single note and had charged-off a portion of the restructured loan, the repayment of the principal and interest contractually due on the entire debt is not

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<sup>26</sup> Refer to the guidance on "Troubled debt restructurings" in the FFIEC Call Report.

reasonably assured given the DSC ratio of 0.88x and nominal other resources. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

The loan can be returned to accrual status<sup>27</sup> if the lender can document that subsequent improvement in the borrower's financial condition has enabled the loan to be brought fully current with respect to principal and interest and the lender expects the contractual balance of the loan (including the partial charge-off) will be fully collected. In addition, interest income may be recognized on a cash basis for the partially charged-off portion of the loan when the remaining recorded balance is considered fully collectible. However, the partial charge-off cannot be reversed.

***TDR Treatment:*** The lender reported the restructured loan as a TDR according to the requirements of its regulatory reports because (a) the borrower is *experiencing financial difficulties* as evidenced by the high leverage, delinquent payments on other projects, and inability to meet the original exit strategy because the borrower was unable to lease the property in a reasonable timeframe; and (b) the lender granted a *concession* as evidenced by deferring payment beyond the repayment ability of the borrower. The charge-off indicates that the lender does not expect full repayment of principal and interest, yet the borrower remains obligated for the full amount of the debt and payments, which is at a level that is not consistent with the borrower's repayment capacity. Because the borrower is not expected to be able to comply with the loan's restructured terms, the lender would likely continue to disclose the loan as a TDR. The examiner concurs with reporting the renewed loan as a TDR.

### ***C. Income Producing Property – Hotel***

**BASE CASE:** A lender originated a \$7.9 million loan to provide permanent financing for the

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<sup>27</sup> Refer to the guidance on “nonaccrual status” in the FFIEC Call Report.

acquisition of a stabilized 3-star hotel property. The borrower is a limited liability company with underlying ownership by two families who guarantee the loan. The loan term is five years, with payments based on a 25-year amortization and with a market interest rate. The LTV was 79 percent based on the hotel's appraised value of \$10 million.

At the end of the five-year term, the borrower's annualized DSC ratio was 0.95x. Due to competition from a well-known 4-star hotel that recently opened within one mile of the property, occupancy rates have declined. The borrower progressively reduced room rates to maintain occupancy rates, but continued to lose daily bookings. Both occupancy and Revenue per Available Room (RevPAR)<sup>28</sup> declined significantly over the past year. The borrower then began working on an initiative to make improvements to the property (i.e., automated key cards, carpeting, bedding, and lobby renovations) to increase competitiveness, and a marketing campaign is planned to announce the improvements and new price structure. The borrower had paid principal and interest as agreed throughout the first five years, and the principal balance had reduced to \$7 million at the end of the five-year term.

**SCENARIO 1:** At maturity, the lender renewed the loan for 12 months on an interest-only basis at a market interest rate that provides for the incremental risk. The extension was granted to enable the borrower to complete the planned renovations, launch the marketing campaign, and achieve the borrower's updated projections for sufficient cash flow to service the debt once the improvements are completed. (If the initiative is successful, the loan officer expects the loan to either be renewed on an amortizing basis or refinanced through another lending entity.) The borrower has a verified, pledged reserve account to cover the improvement expenses. Additionally, the guarantors' updated financial statements indicate that they have sufficient unencumbered liquid assets. Further, the guarantors expressed the willingness to cover any estimated cash flow shortfall through maturity. Based on this information, the lender's analysis indicates that, after deductions for personal obligations and

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<sup>28</sup> Total guest room revenue divided by room count and number of days in the period.

realistic living expenses and verification that there are no contingent liabilities, the guarantors should be able to make interest payments. To date, interest payments have been timely. The lender estimates the property's current "as stabilized" market value at \$9 million, which results in a 78 percent LTV.

***Classification:*** The lender internally graded the loan as a pass and is monitoring the credit. The examiner agreed with the lender's internal loan grade. The examiner concluded that the borrower and guarantors have sufficient resources to support the interest payments; additionally, the borrower's reserve account is sufficient to complete the renovations as planned.

***Nonaccrual Treatment:*** The lender maintained the loan on accrual status as full repayment of principal and interest is reasonably assured from the hotel's and guarantors cash flows, despite a decline in the borrower's cash flow due to competition. The examiner concurred with the lender's accrual treatment.

***TDR Treatment:*** The lender concluded that while the borrower has been affected by competition, the level of deterioration does not warrant TDR treatment. The borrower was not *experiencing financial difficulties* because the combined cash flow generated by the borrower and the liquidity provided by the guarantors should be sufficient to service the debt. Further, there was no history of default by the borrower or guarantors. The examiner concurred with the lender that the loan renewal is not a TDR.

**SCENARIO 2:** At maturity of the original loan, the lender restructured the loan on an interest-only basis at a below market interest rate for 12 months to provide the borrower time to complete its renovation and marketing efforts and increase occupancy levels. At the end of the 12-month period, the hotel's renovation and marketing efforts were completed but unsuccessful. The hotel continued to experience a decline in occupancy levels, resulting in a DSC ratio of 0.60x. The borrower does not have capacity to offer additional incentives to lure customers from the competition. RevPAR has also declined. Current financial information



indicates the borrower has limited ability to continue to make interest payments, and updated projections indicate that the borrower will be below break-even performance for the next 12 months. The borrower has been sporadically delinquent on prior interest payments. The guarantors are unable to support the loan as they have unencumbered limited liquid assets and are highly leveraged. The lender is in the process of renewing the loan again.

The most recent hotel appraisal, dated as of the time of the first restructuring, reports an “as stabilized” appraised value of \$7.2 million (\$6.7 million for the real estate and \$500,000 for the tangible personal property of furniture, fixtures, and equipment), resulting in an LTV of 97 percent. The appraisal does not account for the diminished occupancy, and its assumptions significantly differ from current projections. A new valuation is needed to ascertain the current value of the property.

***Classification:*** The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender’s treatment due to the borrower’s diminished ongoing ability to make payments, guarantors’ limited ability to support the loan, and the reduced collateral position. The lender is obtaining a new valuation and will adjust the internal classification, if necessary, based on the updated value.

***Nonaccrual Treatment:*** The lender maintained the loan on an accrual basis because the borrower demonstrated an ability to make interest payments. The examiner did not concur with this treatment as the loan was not restructured on reasonable repayment terms, the borrower has insufficient cash resources to service the below market interest rate on an interest-only basis, and the collateral margin has narrowed and may be narrowed further with a new valuation, which collectively indicate that full repayment of principal and interest is in doubt. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

***TDR Treatment:*** The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties*: the hotel’s ability to generate sufficient

cash flows to service the debt is questionable as the occupancy levels and resultant net operating income (NOI) continue to decline, the borrower has been delinquent, and collateral value has declined. The lender made a *concession* by extending the loan on an interest-only basis at a below market interest rate. The examiner concurred with the lender's TDR treatment.

**SCENARIO 3:** At maturity of the original loan, the lender restructured the debt for one year on an interest-only basis at a below market interest rate to give the borrower additional time to complete renovations and increase marketing efforts. While the combined borrower/guarantors' liquidity indicated they could cover any cash flow shortfall until maturity of the restructured note, the borrower only had 50 percent of the funds to complete its renovations in reserve. Subsequently, the borrower attracted a sponsor to obtain the remaining funds necessary to complete the renovation plan and marketing campaign. Eight months later, the hotel experienced an increase in its occupancy and achieved a DSC ratio of 1.20x on an amortizing basis. Updated projections indicated the borrower would be at or above the 1.20x DSC ratio for the next 12 months, based on market terms and rate. The borrower and the lender then agreed to restructure the loan again with monthly payments that amortize the debt over 20 years, consistent with the current market terms and rates. Since the date of the second restructuring, the borrower has made all principal and interest payments as agreed for six consecutive months.

***Classification:*** The lender internally classified the most recent restructured loan substandard. The examiner agreed with the lender's initial substandard grade at the time of the subject restructuring, but now considers the loan as a pass as the borrower was no longer having financial difficulty and has demonstrated the ability to make payments according to the modified principal and interest terms for more than six consecutive months.

***Nonaccrual Treatment:*** The original restructured loan was placed in nonaccrual status.

The lender initially maintained the most recent restructured loan in nonaccrual status as well, but returned it to an accruing status after the borrower made six consecutive monthly principal and interest payments. The lender expects full repayment of principal and interest. The examiner concurred with the lender's accrual treatment.

***TDR Treatment:*** The lender reported the first restructuring as a TDR. With the first restructuring, the lender determined that the borrower was *experiencing financial difficulties* as indicated by depleted cash resources and deteriorating financial condition. The lender granted a *concession* on the first restructuring by providing a below market interest rate. At the time of the second restructuring, the borrower's financial condition had improved, and the borrower was no longer experiencing financial difficulty; the lender did not grant a *concession* on the second restructuring as the renewal was granted at a market interest rate and amortizing terms, thus the latest restructuring is no longer classified as a TDR. The examiner concurred with the lender.

**SCENARIO 4:** The lender extended the original amortizing loan for 12 months at a market interest rate. The borrower is now experiencing a six-month delay in completing the renovations due to a conflict with the contractor hired to complete the renovation work, and the current DSC ratio is 0.85x. A current valuation has not been ordered. The lender estimates the property's current "as stabilized" market value is \$7.8 million, which results in an estimated 90 percent LTV. The lender did receive updated projections, but the borrower is now unlikely to achieve break-even cash flow within the 12-month extension timeframe due to the renovation delays. At the time of the extension, the borrower and guarantors had sufficient liquidity to cover the debt service during the twelve-month period. The guarantors also demonstrated a willingness to support the loan by making payments when necessary, and the loan has not gone delinquent. With the guarantors' support, there is sufficient liquidity to make payments to maturity, though such resources are declining rapidly

***Classification:*** The lender internally graded the loan as pass and is monitoring the credit.

The examiner disagreed with the lender's grading and listed the loan as special mention. While the borrower and guarantor can cover the debt service shortfall in the near-term, the duration of their support may not extend long enough to replace lost cash flow from operations due to delays in the renovation work. The primary source of repayment does not fully cover the loan as evidenced by a DSC ratio of 0.85x. It appears that competition from the new hotel will continue to adversely affect the borrower's cash flow until the renovations are complete, and if cash flow deteriorates further, the borrower and guarantors may be required to use more liquidity to support loan payments and ongoing business operations. The examiner also recommended the lender obtain a new valuation.

***Nonaccrual Treatment:*** The lender maintained the loan on accrual status. The borrower and legally obligated guarantors have demonstrated the ability and willingness to make the regularly scheduled payments and, even with the decline in the borrower's creditworthiness, global cash resources appear sufficient to make these payments, and the ultimate full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment.

***TDR Treatment:*** While the borrower is experiencing some financial deterioration, the borrower is not *experiencing financial difficulties* as the borrower and guarantors have sufficient cash resources to service the debt. The lender expects full collection of principal and interest from the borrower's operating income and global cash resources. The examiner concurred with the lender's rationale that the loan is not a TDR.

#### ***D. Acquisition, Development and Construction – Residential***

**BASE CASE:** The lender originated a \$4.8 million acquisition and development (A&D) loan and a \$2.4 million construction revolving line of credit (revolver) for the development and construction of a 48-lot single-family project. The maturity for both loans is three years, and both are priced at a market interest rate; both loans also have an interest reserve. The LTV on

the A&D loan is 75 percent based on an “as complete” value of \$6.4 million. Up to 12 units at a time will be funded under the construction revolver at the lesser of 80 percent LTV or 100 percent of costs. The builder is allowed two speculative (“spec”) units (including one model). The remaining units must be pre-sold with an acceptable deposit and a pre-qualified mortgage. As units are settled, the construction revolver will be repaid at 100 percent (or par); the A&D loan will be repaid at 120 percent, or \$120,000 (\$4.8 million/48 units x 120 percent). The average sales price is projected to be \$500,000, and total construction cost to build each unit is estimated to be \$200,000. Assuming total cost is lower than value, the average release price will be \$320,000 (\$120,000 A&D release price plus \$200,000 construction costs).

Estimated time for development is 12 months; the appraiser estimated absorption of two lots per month for total sell-out to occur within three years (thus, the loan would be repaid upon settlement of the 40th unit, or the 32nd month of the loan term). The borrower is required to curtail the A&D loan by six lots, or \$720,000, at the 24th month, and another six lots, or \$720,000, by the 30th month.

**SCENARIO 1:** Due to issues with the permitting and approval process by the county, the borrower’s development was delayed by 18 months. Further delays occurred because the borrower was unable to pave the necessary roadways due to excessive snow and freezing temperatures. The lender waived both \$720,000 curtailment requirements due to the delays. Demand for the housing remains unchanged.

At maturity, the lender renewed the \$4.8 million outstanding A&D loan balance and the \$2.4 million construction revolver for 24 months at a market interest rate that provides for the incremental risk. The interest reserve for the A&D loan has been depleted as the lender had continued to advance funds to pay the interest charges despite the delays in development. Since depletion of the interest reserve, the borrower has made the last several payments out-of-pocket.

Development is now complete, and construction has commenced on eight units (two “spec” units and six pre-sold units). Combined borrower and guarantor liquidity show they can cover any debt service shortfall until the units begin to settle and the project is cash flowing. The lender estimates that the property’s current “as complete” value is \$6 million, resulting in an 80 percent LTV. The curtailment schedule was re-set to eight lots, or \$960,000, by month 12, and another eight lots, or \$960,000, by month 18. A new appraisal has not been ordered; however, the lender noted in the file that, if the borrower does not meet the absorption projections of six lots/quarter within six months of booking the renewed loan, the lender will obtain a new appraisal.

***Classification:*** The lender internally graded the restructured loans as pass and is monitoring the credits. The examiner agreed, as the borrower and guarantor can continue making payments on reasonable terms and the project is moving forward supported by housing demand and is consistent with the builder’s development plans. However, the examiner noted weaknesses in the lender’s loan administrative practices as the financial institution did not (1) suspend the interest reserve during the development delay and (2) obtain an updated collateral valuation.

***Nonaccrual Treatment:*** The lender maintained the loans on accrual status. The project is moving forward, the borrower has demonstrated the ability to make the regularly scheduled payments after depletion of the interest reserve, global cash resources from the borrower and guarantor appears sufficient to make these payments, and full repayment of principal and interest is expected. The examiner concurred with the lender’s accrual treatment.

***TDR Treatment:*** The borrower is not *experiencing financial difficulties* as the borrower and guarantor have sufficient means to service the debt, and there is no history of default. With the continued supportive housing market conditions, the lender expects full collection of principal and interest from sales of the lots. The examiner concurred with

the lender's rationale that the renewal is not a TDR.

**SCENARIO 2:** Due to weather and contractor issues, development was not completed until month 24, a year behind the original schedule. The borrower began pre-marketing, but sales have been slow due to deteriorating market conditions in the region. The borrower has achieved only eight pre-sales during the past six months. The borrower recently commenced construction on the pre-sold units.

At maturity, the lender renewed the \$4.8 million A&D loan balance and \$2.4 million construction revolver on a 12-month interest-only basis at a market interest rate, with another 12-month option predicated upon \$1 million in curtailments having occurred during the first renewal term (the lender had waived the initial term curtailment requirements). The lender also renewed the construction revolver for a one-year term and reduced the number of "spec" units to just one, which also will serve as the model. A recent appraisal estimates that absorption has dropped to four lots per quarter for the first two years and assigns an "as complete" value of \$5.3 million, for an LTV of 91 percent. The interest reserve is depleted, and the borrower has been paying interest out-of-pocket for the past few months. Updated borrower and guarantor financial statements indicate the continued ability to cover interest-only payments for the next 12 to 18 months.

**Classification:** The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender's treatment due to the deterioration and uncertainty surrounding the market (as evidenced by slower than anticipated sales on the project), the lack of principal reduction, and the reduced collateral margin.

**Nonaccrual Treatment:** The lender maintained the loan on an accrual basis because the development is complete, the borrower has pre-sales and construction has commenced, and the borrower and guarantor have sufficient means to make interest payments at a market interest rate until the earlier of maturity or the project begins to cash flow. The examiner concurred with the lender's accrual treatment.

***TDR Treatment:*** While the borrower is experiencing some financial deterioration, the borrower is not *experiencing financial difficulties* as the borrower and guarantor have sufficient means to service the debt. The lender expects full collection of principal and interest from the sale of the units. The examiner concurred with the lender's rationale that the renewal is not a TDR.

**SCENARIO 3:** Lot development was completed on schedule, and the borrower quickly sold and settled the first 10 units. At maturity, the lender renewed the \$3.6 million A&D loan balance (\$4.8 million reduced by the sale and settlement of the 10 units (\$120,000 release price x 10) to arrive at \$3.6 million) and \$2.4 million construction revolver on a 12-month interest-only basis at a below market interest rate.

The borrower then sold an additional 10 units to an investor; the loan officer (new to the financial institution) mistakenly marked these units as pre-sold and allowed construction to commence on all 10 units. Market conditions then deteriorated quickly, and the investor defaulted under the terms of the bulk contract. The units were completed, but the builder has been unable to re-sell any of the units, recently dropping the sales price by 10 percent and engaging a new marketing firm, which is working with several potential buyers.

A recent appraisal estimates that absorption has dropped to three lots per quarter and assigns an "as complete" value of \$2.3 million for the remaining 28 lots, resulting in an LTV of 156 percent. A bulk appraisal of the 10 units assigns an "as-is" value of the units of \$4.0 million (\$400,000/unit). The loans are cross-defaulted and cross-collateralized; the LTV on a combined basis is 95 percent (\$6 million outstanding debt (A&D plus revolver) divided by \$6.3 million in combined collateral value). Updated borrower and guarantor financial statements indicate a continued ability to cover interest-only payments for the next 12 months at the reduced rate; however, this may be limited in the future given other troubled projects in the borrower's portfolio that have been affected by market conditions.

The lender modified the release price for each unit to net proceeds; any additional proceeds as



units are sold will go towards repayment of the A&D loan. Assuming the units sell at a 10 percent reduction, the lender calculates the average sales price would be \$450,000. The financial institution's prior release price was \$320,000 (\$120,000 for the A&D loan and \$200,000 for the construction revolver). As such (by requiring net proceeds), the financial institution will be receiving an additional \$130,000 per lot, or \$1.3 million for the completed units, to repay the A&D loan (\$450,000 average sales price less \$320,000 bank's release price equals \$130,000). Assuming the borrower will have to pay \$30,000 in related sales/settlement costs leaves approximately \$100,000 remaining per unit to apply towards the A&D loan, or \$1 million total for the remaining 10 units (\$100,000 times 10).

***Classification:*** The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender's treatment due to the borrower and guarantor's diminished ability to make interest payments (even at the reduced rate), the stalled status of the project, and the reduced collateral protection.

***Nonaccrual Treatment:*** The lender maintained the loan on an accrual basis because the borrower had previously demonstrated an ability to make interest payments. The examiner disagreed as the loan was not restructured on reasonable repayment terms. While the borrower and guarantor may be able to service the debt at a below market interest rate in the near term using other unencumbered liquid assets, other projects in their portfolio are also affected by poor market conditions and may require significant liquidity contributions, which could affect their ability to support the loan. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

***TDR Treatment:*** The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties* as evidenced by the borrower's inability to re-sell the units, their diminished ability to make interest payments (even at a reduced rate), and other troubled projects in the borrower's portfolio. The lender granted a

*concession* with the interest-only terms at a below market interest rate. The examiner concurred with the lender's TDR treatment.

***E. Construction Loan – Single Family Residence***

**BASE CASE:** The lender originated a \$1.2 million construction loan on a single-family “spec” residence with a 15-month maturity to allow for completion and sale of the property. The loan required monthly interest-only payments at a market interest rate and was based on an “as completed” LTV of 70 percent at origination. During the original loan construction phase, the borrower was able to make all interest payments from personal funds. At maturity, the home had been completed, but not sold, and the borrower was unable to find another lender willing to finance this property under similar terms.

**SCENARIO 1:** At maturity, the lender restructured the loan for one year on an interest-only basis at a below market interest rate to give the borrower more time to sell the “spec” home. Current financial information indicates the borrower has limited ability to continue to make interest-only payments from personal funds. If the residence does not sell by the revised maturity date, the borrower plans to rent the home. In this event, the lender will consider modifying the debt into an amortizing loan with a 20-year maturity, which would be consistent with this type of income-producing investment property. Any shortfall between the net rental income and loan payments would be paid by the borrower. Due to declining home values, the LTV at the renewal date was 90 percent.

***Classification:*** The lender internally classified the loan substandard and is monitoring the credit. The examiner agreed with the lender's treatment due to the borrower's diminished ongoing ability to make payments and the reduced collateral position.

***Nonaccrual Treatment:*** The lender maintained the loan on an accrual basis because the borrower demonstrated an ability to make interest payments during the construction phase. The examiner did not concur with this treatment because the loan was not

restructured on reasonable repayment terms. The borrower had limited capacity to continue to service the debt, even on an interest-only basis at a below market interest rate, and the deteriorating collateral margin indicated that full repayment of principal and interest was not reasonably assured. The examiner instructed the lender to place the loan in nonaccrual status.

***TDR Treatment:*** The lender reported the restructured loan as a TDR. The borrower was *experiencing financial difficulties* as indicated by depleted cash reserves, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. A *concession* was provided by renewing the loan with a deferral of principal payments, at a below market interest rate (compared to the rate charged on an investment property) for an additional year when the loan was no longer in the construction phase. The examiner concurred with the lender's TDR treatment.

**SCENARIO 2:** At maturity of the original loan, the lender restructured the debt for one year on an interest-only basis at a below market interest rate to give the borrower more time to sell the "spec" home. Eight months later, the borrower rented the property. At that time, the borrower and the lender agreed to restructure the loan again with monthly payments that amortize the debt over 20 years at a market interest rate for a residential investment property. Since the date of the second restructuring, the borrower had made all payments for over six consecutive months.

***Classification:*** The lender internally classified the restructured loan substandard. The examiner agreed with the lender's initial substandard grade at the time of the restructuring, but now considered the loan as a pass due to the borrower's demonstrated ability to make payments according to the reasonably modified terms for more than six consecutive months.

***Nonaccrual Treatment:*** The lender initially placed the restructured loan in nonaccrual

status but returned it to accrual after the borrower made six consecutive monthly payments. The lender expects full repayment of principal and interest from the rental income. The examiner concurred with the lender's accrual treatment.

***TDR Treatment:*** The lender reported the first restructuring as a TDR. At the time of the first restructure, the lender determined that the borrower was *experiencing financial difficulties* as indicated by depleted cash resources and a weak financial condition. The lender granted a *concession* on the first restructuring as evidenced by the below market rate.

At the second restructuring, the lender determined that the borrower was not *experiencing financial difficulties* due to the borrower's improved financial condition. Further, the lender did not grant a *concession* on the second restructuring as that loan is at market interest rate and terms. Therefore, the lender determined that the second restructuring is no longer a TDR. The examiner concurred with the lender.

**SCENARIO 3:** The lender restructured the loan for one year on an interest-only basis at a below market interest rate to give the borrower more time to sell the "spec" home. The restructured loan has become more than 90 days past due, and the borrower has not been able to rent the property. Based on current financial information, the borrower does not have the capacity to service the debt. The lender considers repayment to be contingent upon the sale of the property. Current market data reflects few sales, and similar new homes in this property's neighborhood are selling within a range of \$750,000 to \$900,000 with selling costs equaling 10 percent, resulting in anticipated net sales proceeds between \$675,000 and \$810,000.

***Classification:*** The lender graded \$390,000 loss (\$1.2 million loan balance less the maximum estimated net sales proceeds of \$810,000), \$135,000 doubtful based on the range in the anticipated net sales proceeds, and the remaining balance of \$675,000 substandard. The examiner agreed, as this classification treatment results in the recognition of the credit risk in the collateral-dependent loan based on the property's value

less costs to sell. The examiner instructed management to obtain information on the current valuation on the property.

***Nonaccrual Treatment:*** The lender placed the loan in nonaccrual status when it became 60 days past due (reversing all accrued but unpaid interest) because the lender determined that full repayment of principal and interest was not reasonably assured. The examiner concurred with the lender's nonaccrual treatment.

***TDR Treatment:*** The lender reported the loan as a TDR until foreclosure of the property and its transfer to other real estate owned. The lender determined that the borrower was continuing to *experience financial difficulties* as indicated by depleted cash reserves, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. In addition, the lender granted a *concession* by reducing the interest rate to a below market level. The examiner concurred with the lender's TDR treatment.

**SCENARIO 4:** The lender committed an additional \$48,000 for an interest reserve and extended the \$1.2 million loan for 12 months at a below market interest rate with monthly interest-only payments. At the time of the examination, \$18,000 of the interest reserve had been added to the loan balance. Current financial information obtained during the examination reflects the borrower has no other repayment sources and has not been able to sell or rent the property. An updated appraisal supports an "as is" value of \$952,950. Selling costs are estimated at 15 percent, resulting in anticipated net sales proceeds of \$810,000.

***Classification:*** The lender internally graded the loan as pass and is monitoring the credit. The examiner disagreed with the internal grade. The examiner concluded that the loan was not restructured on reasonable repayment terms because the borrower has limited capacity to service the debt, and the reduced collateral margin indicated that full repayment of principal and interest was not assured. After discussing regulatory reporting requirements with the examiner, the lender reversed the \$18,000 interest capitalized out of

the loan balance and interest income. Further, the examiner classified \$390,000 loss based on the adjusted \$1.2 million loan balance less estimated net sales proceeds of \$810,000, which was classified substandard. This classification treatment recognizes the credit risk in the collateral-dependent loan based on the property's market value less costs to sell. The examiner also provided supervisory feedback to management for the inappropriate use of interest reserves and lack of current financial information in making that decision. The remaining interest reserve of \$30,000 is not subject to adverse classification because the loan should be placed in nonaccrual status.

***Nonaccrual Treatment:*** The lender maintained the loan on accrual status. The examiner did not concur with this treatment. The loan was not restructured on reasonable repayment terms, the borrower has limited capacity to service a below market interest rate on an interest-only basis, and the reduced collateral margin indicates that full repayment of principal and interest is not assured. The lender's decision to provide a \$48,000 interest reserve was not supported, given the borrower's inability to repay it. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual, and reversed the capitalized interest to be consistent with regulatory reporting instructions. The lender also agreed to not recognize any further interest income from the interest reserve.

***TDR Treatment:*** The lender reported the restructured loan as a TDR. The borrower is *experiencing financial difficulties* as indicated by depleted cash reserves, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. A *concession* was provided by renewing the loan with a deferral of principal payments, at a below market interest rate (compared to other investment properties) for an additional year when the loan was no longer in the construction phase. The examiner concurred with the lender's TDR treatment.

## ***F. Construction Loan – Land Acquisition, Condominium Construction and Conversion***

**BASE CASE:** The lender originally extended a \$50 million loan for the purchase of vacant land and the construction of a luxury condominium project. The loan was interest-only and included an interest reserve to cover the monthly payments until construction was complete. The developer bought the land and began construction after obtaining purchase commitments for 1/3 of the 120 planned units, or 40 units. Many of these pending sales were speculative with buyers committing to buy multiple units with minimal down payments. The demand for luxury condominiums in general has declined since the borrower launched the project, and sales have slowed significantly over the past year. The lack of demand is attributed to a slowdown in the economy. As a result, most of the speculative buyers failed to perform on their purchase contracts and only a limited number of the other planned units have been pre-sold.

The developer experienced cost overruns on the project and subsequently determined it was in the best interest to halt construction with the property 80 percent completed. The outstanding loan balance is \$44 million with funds used to pay construction costs, including cost overruns and interest. The borrower estimates an additional \$10 million is needed to complete construction. Current financial information reflects that the developer does not have sufficient cash flow to pay interest (the interest reserve has been depleted); and, while the developer does have equity in other assets, there is doubt about the borrower's ability to complete the project.

**SCENARIO 1:** The borrower agrees to grant the lender a second lien on an apartment project in its portfolio, which provides \$5 million in additional collateral support. In return, the lender advanced the borrower \$10 million to finish construction. The condominium project was completed shortly thereafter. The lender also agreed to extend the \$54 million loan (\$44 million outstanding balance plus \$10 million in new money) for 12 months at a

market interest rate that provides for the incremental risk, to give the borrower additional time to market the property. The borrower agreed to pay interest whenever a unit was sold, with any outstanding balance due at maturity.

The lender obtained a recent appraisal on the condominium building that reported a prospective “as complete” market value of \$65 million, reflecting a 24-month sell-out period and projected selling costs of 15 percent of the sales price. Comparing the \$54 million loan amount against the \$65 million “as complete” market value plus the \$5 million pledged in additional collateral (totaling \$70 million) results in an LTV of 77 percent. The lender used the prospective “as complete” market value in its analysis and decision to fund the completion and sale of the units and to maximize its recovery on the loan.

***Classification:*** The lender internally classified the \$54 million loan as substandard due to the units not selling as planned and the project’s limited ability to service the debt despite the 1.3x gross collateral margin. The examiner agreed with the lender’s internal grade.

***Nonaccrual Treatment:*** The lender maintained the loan on accrual status due to the protection afforded by the collateral margin. The examiner did not concur with this treatment due to the uncertainty about the borrower’s ability to sell the units and service the debt, raising doubts as to the full repayment of principal and interest. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

***TDR Treatment:*** The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties*, as demonstrated by the insufficient cash flow to service the debt, concerns about the project’s viability, and, given current market conditions and project status, the unlikely possibility of refinance. In addition, the lender provided a *concession* by advancing additional funds to finish construction, deferring interest payments until a unit was sold, and deferring principal pay downs on any unsold units until the maturity date when any remaining accrued interest plus principal are due.



The examiner concurred with the lender's TDR treatment.

**SCENARIO 2:** A recent appraisal of the property reflects that the highest and best use would be conversion to an apartment building. The appraisal reports a prospective "as complete" market value of \$60 million upon conversion to an apartment building and a \$67 million prospective "as stabilized" market value upon the property reaching stabilized occupancy. The borrower agrees to grant the lender a second lien on an apartment building in its portfolio, which provides \$5 million in additional collateral support.

In return, the lender advanced the borrower \$10 million, which is needed to finish construction and convert the project to an apartment complex. The lender also agreed to extend the \$54 million loan for 12 months at a market interest rate that provides for the incremental risk, to give the borrower time to lease the apartments. Interest payments are deferred. The \$60 million "as complete" market value plus the \$5 million in other collateral results in an LTV of 83 percent. The prospective "as complete" market value is primarily relied on as the loan is funding the conversion of the condominium to apartment building.

***Classification:*** The lender internally classified the \$54 million loan as substandard due to the units not selling as planned and the project's limited ability to service the debt. The collateral coverage provides adequate support to the loan with a 1.2x gross collateral margin. The examiner agreed with the lender's internal grade.

***Nonaccrual Treatment:*** The lender determined the loan should be placed in nonaccrual status due to an oversupply of units in the project's submarket, and the borrower's untested ability to lease the units and service the debt, raising concerns as to the full repayment of principal and interest. The examiner concurred with the lender's nonaccrual treatment.

***TDR Treatment:*** The lender reported the restructured loan as a TDR as the borrower is *experiencing financial difficulties*, as demonstrated by the insufficient cash flow to service the debt, concerns about the project's viability, and, given current market conditions and

project status, the unlikely possibility for the borrower to refinance at this time. In addition, the lender provided a *concession* by advancing additional funds to finish construction and deferring interest payments until the maturity date without a defined exit strategy. The examiner concurred with the lender's TDR treatment.

***G. Commercial Operating Line of Credit in Connection with Owner Occupied Real Estate***

**BASE CASE:** Two years ago, the lender originated a CRE loan at a market interest rate to a borrower whose business occupies the property. The loan was based on a 20-year amortization period with a balloon payment due in three years. The LTV equaled 70 percent at origination. A year ago, the lender financed a \$5 million operating line of credit for seasonal business operations at market terms. The operating line of credit had a one-year maturity with monthly interest payments and was secured with a blanket lien on all business assets. Borrowings under the operating line of credit are based on accounts receivable that are reported monthly in borrowing base reports, with a 75 percent advance rate against eligible accounts receivable that are aged less than 90 days old. Collections of accounts receivable are used to pay down the operating line of credit. At maturity of the operating line of credit, the borrower's accounts receivable aging report reflected a growing trend of delinquency, causing the borrower temporary cash flow difficulties. The borrower has recently initiated more aggressive collection efforts.

**SCENARIO 1:** The lender renewed the \$5 million operating line of credit for another year, requiring monthly interest payments at a market interest rate, and principal to be paid down by accounts receivable collections. The borrower's liquidity position has tightened but remains satisfactory, cash flow available to service all debt is 1.20x, and both loans have been paid according to the contractual terms. The primary repayment source for the operating line of credit is conversion of accounts receivable to cash. Although payments have slowed for some customers, most customers are paying within 90 days of invoice. The primary

repayment source for the real estate loan is from business operations, which remain satisfactory, and an updated appraisal is not considered necessary.

**Classification:** The lender internally graded both loans as pass and is monitoring the credits. The examiner agreed with the lender's analysis and the internal grades. The lender is monitoring the trend in the accounts receivable aging report and the borrower's ongoing collection efforts.

**Nonaccrual Treatment:** The lender determined that both the real estate loan and the renewed operating line of credit may remain on accrual status as the borrower has demonstrated an ongoing ability to perform, has the financial capacity to pay a market interest rate, and full repayment of principal and interest is reasonably assured. The examiner concurred with the lender's accrual treatment.

**TDR Treatment:** The lender concluded that while the borrower has been affected by declining economic conditions, the renewal of the operating line of credit did not result in a TDR because the borrower is not *experiencing financial difficulties* and has the ability to repay both loans (which represent most of its outstanding obligations) at a market interest rate. The lender expects full collection of principal and interest from the collection of accounts receivable and the borrower's operating income. The examiner concurred with the lender's rationale that the loan renewal is not a TDR.

**SCENARIO 2:** The lender restructured the operating line of credit by reducing the line amount to \$4 million, at a below market interest rate. This action is expected to alleviate the borrower's cash flow problem. The borrower is still considered to be a viable business even though its financial performance has continued to deteriorate, with sales and profitability declining. The trend in accounts receivable delinquencies is worsening, resulting in reduced liquidity for the borrower. Cash flow problems have resulted in sporadic over advances on the \$4 million operating line of credit, where the loan balance exceeds eligible collateral in the borrowing base. The borrower's net operating income has declined but reflects the

capacity to generate a 1.08x DSC ratio for both loans, based on the reduced rate of interest for the operating line of credit. The terms on the real estate loan remained unchanged. The lender estimated the LTV on the real estate loan to be 90 percent. The operating line of credit currently has sufficient eligible collateral to cover the outstanding line balance, but customer delinquencies have been increasing.

***Classification:*** The lender internally classified both loans substandard due to deterioration in the borrower's business operations and insufficient cash flow to repay the debt at market terms. The examiner agreed with the lender's analysis and the internal grades. The lender will monitor the trend in the business operations, accounts receivable, profitability, and cash flow. The lender may need to order a new appraisal if the DSC ratio continues to fall and the overall collateral margin further declines.

***Nonaccrual Treatment:*** The lender reported both the restructured operating line of credit and the real estate loan on a nonaccrual basis. The operating line of credit was not renewed on market interest rate repayment terms, the borrower has an increasingly limited capacity to service the below market interest rate debt, and there is insufficient support to demonstrate an ability to meet the new payment requirements. The borrower's ability to continue to perform on the operating line of credit and real estate loan is not assured due to deteriorating business performance caused by lower sales and profitability and higher customer delinquencies. In addition, the collateral margin indicates that full repayment of all of the borrower's indebtedness is questionable, particularly if the borrower fails to continue being a going concern. The examiner concurred with the lender's nonaccrual treatment.

***TDR Treatment:*** The lender reported the restructured operating line of credit as a TDR because the borrower is *experiencing financial difficulties* (as evidenced by the borrower's sporadic over advances, an increasing trend in accounts receivable delinquencies, and uncertain ability to repay the loans) and the lender *granted a concession* on the line of

credit through a below market interest rate. The lender concluded that the real estate loan should not be reported as TDR since that loan is performing and had not been restructured. The examiner concurred with the lender's TDR treatments.

#### ***H. Land Loan***

**BASE CASE:** Three years ago, the lender originated a \$3.25 million loan to a borrower for the purchase of raw land that the borrower was seeking to have zoned for residential use. The loan terms were three years interest-only at a market interest rate; the borrower had sufficient funds to pay interest from cash flow. The appraisal at origination assigned an "as is" market value of \$5 million, which resulted in a 65 percent LTV. The zoning process took longer than anticipated, and the borrower did not obtain full approvals until close to the maturity date. Now that the borrower successfully obtained the residential zoning, the borrower has been seeking construction financing to repay the land loan. At maturity, the borrower requested a 12-month extension to provide additional time to secure construction financing which would include repayment of the subject loan.

**SCENARIO 1:** The borrower provided the lender with current financial information, demonstrating the continued ability to make monthly interest payments and principal curtailments of \$150,000 per quarter. Further, the borrower made a principal payment of \$250,000 in exchange for a 12-month extension of the loan. The borrower also owned an office building with an "as stabilized" market value of \$1 million and pledged the property as additional unencumbered collateral, granting the lender a first lien. The borrower's personal financial information also demonstrates that cash flow from personal assets and the rental income generated by the newly pledged office building are sufficient to fully amortize the land loan over a reasonable period. A decline in market value since origination was due to a change in density; the project was originally intended as 60 lots but was subsequently zoned as 25 single-family lots because of a change in the county's approval process. A recent

appraisal of the raw land reflects an “as is” market value of \$3 million, which results in a 75 percent LTV when combined with the additional collateral and after the principal reduction. The lender restructured the loan into a \$3 million loan with quarterly curtailments for another year at a market interest rate that provides for the incremental risk.

***Classification:*** The lender internally graded the loan as pass due to adequate cash flow from the borrower’s personal assets and rental income generated by the office building to make principal and interest payments. Also, the borrower provided a principal curtailment and additional collateral to maintain a reasonable LTV. The examiner agreed with the lender’s internal grade.

***Nonaccrual Treatment:*** The lender maintained the loan on accrual status, as the borrower has sufficient funds to cover the debt service requirements for the next year. Full repayment of principal and interest is reasonably assured from the collateral and the borrower’s financial resources. The examiner concurred with the lender’s accrual treatment.

***TDR Treatment:*** The lender concluded that the borrower was not *experiencing financial difficulties* because the borrower has the ability to service the renewed loan, which was prudently underwritten and has a market interest rate. The examiner concurred with the lender’s rationale that the renewed loan is not a TDR.

**SCENARIO 2:** The borrower provided the lender with current financial information that indicated the borrower is unable to continue to make interest-only payments. The borrower has been sporadically delinquent up to 60 days on payments. The borrower is still seeking a loan to finance construction of the project, and has not been able to obtain a takeout commitment; it is unlikely the borrower will be able to obtain financing, since the borrower does not have the equity contribution most lenders require as a condition of closing a construction loan. A decline in value since origination was due to a change in local zoning density; the project was originally intended as 60 lots but was subsequently zoned as 25

single-family lots. A recent appraisal of the property reflects an “as is” market value of \$3 million, which results in a 108 percent LTV. The lender extended the \$3.25 million loan at a market interest rate for one year with principal and interest due at maturity.

***Classification:*** The lender internally graded the loan as pass because the loan is currently not past due and is at a market interest rate. Also, the borrower is trying to obtain takeout construction financing. The examiner disagreed with the internal grade and adversely classified the loan, as discussed below. The examiner concluded that the loan was not restructured on reasonable repayment terms because the borrower does not have the capacity to service the debt and full repayment of principal and interest is not assured. The examiner classified \$550,000 loss (\$3.25 million loan balance less \$2.7 million, based on the current appraisal of \$3 million less estimated cost to sell of 10 percent or \$300,000). The examiner classified the remaining \$2.7 million balance substandard. This classification treatment recognizes the credit risk in this collateral dependent loan based on the property’s market value less costs to sell.

***Nonaccrual Treatment:*** The lender maintained the loan on accrual status. The examiner did not concur with this treatment and instructed the lender to place the loan in nonaccrual status because the borrower does not have the capacity to service the debt, value of the collateral is permanently impaired, and full repayment of principal and interest is not assured.

***TDR Treatment:*** The lender reported the restructured loan as a TDR. The borrower is *experiencing financial difficulties* as indicated by the inability to refinance this debt, the inability to repay the loan at maturity in a manner consistent with the original exit strategy, and the inability to make interest-only payments going forward. *A concession was provided* by renewing the loan with a deferral of principal and interest payments for an additional year when the borrower was unable to obtain takeout financing. The examiner concurred with the lender’s TDR designation.

## ***I. Multi-Family Property***

**BASE CASE:** The lender originated a \$6.4 million loan for the purchase of a 25-unit apartment building. The loan maturity is five years, and principal and interest payments are based on a 30-year amortization at a market interest rate. The LTV was 75 percent (based on an \$8.5 million value), and the DSC ratio was 1.50x at origination (based on a 30-year principal and interest amortization).

Leases are typically 12-month terms with an additional 12-month renewal option. The property is 88 percent leased (22 of 25 units rented). Due to poor economic conditions, delinquencies have risen from two units to eight units, as tenants have struggled to make ends meet. Six of the eight units are 90 days past due, and these tenants are facing eviction.

**SCENARIO 1:** At maturity, the lender renewed the \$5.9 million loan balance on principal and interest payments for 12 months at a market interest rate that provides for the incremental risk. The borrower had not been delinquent on prior payments. Current financial information indicates that the DSC ratio dropped to 0.80x because of the rent payment delinquencies. Combining borrower and guarantor liquidity shows they can cover cash flow shortfall until maturity (including reasonable capital expenditures since the building was recently renovated). Borrower projections show a return to break-even within six months since the borrower plans to decrease rents to be more competitive and attract new tenants. The lender estimates that the property's current "as stabilized" market value is \$7 million, resulting in an 84 percent LTV. A new appraisal has not been ordered; however, the lender noted in the file that, if the borrower does not meet current projections within six months of booking the renewed loan, the lender will obtain a new appraisal.

***Classification:*** The lender internally graded the renewed loan as pass and is monitoring the credit. The examiner disagreed with the lender's analysis and classified the loan as substandard. While the borrower and guarantor can cover the debt service shortfall in the



near-term using additional guarantor liquidity, the duration of the support may be less than the lender anticipates if the leasing fails to materialize as projected. Economic conditions are poor, and the rent reduction may not be enough to improve the property's performance. Lastly, the lender failed to obtain an updated collateral valuation, which represents an administrative weakness.

***Nonaccrual Treatment:*** The lender maintained the loan on accrual status. The borrower has demonstrated the ability to make the regularly scheduled payments and, even with the decline in the borrower's creditworthiness, the borrower and guarantor appear to have sufficient cash resources to make these payments if projections are met, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment.

***TDR Treatment:*** While the borrower is experiencing some financial deterioration, the borrower is not *experiencing financial difficulties* as the borrower and guarantor have sufficient means to service the debt, and there was no history of default. The lender expects full collection of principal and interest from the borrower's operating income if they meet projections. The examiner concurred with the lender's rationale and TDR treatment.

**SCENARIO 2:** At maturity, the lender renewed the \$5.9 million loan balance on a 12-month interest-only basis at a below market interest rate. In response to an event that caused severe economic conditions, the federal and state governments enacted moratoriums on all rent payments. The borrower has been paying as agreed; however, cash flow has been severely impacted by the rent moratoriums. While the moratoriums do not forgive the rent (or unpaid fees), they do prevent evictions for unpaid rent and have been in effect for the past six months. As a result, the borrower's cash flow is severely stressed, and the borrower has asked for temporary relief of the interest payments. In addition, a review of the current rent roll indicates that five of the 25 units are now vacant. A recent appraisal values the property at \$6

million (98 percent LTV). Updated borrower and guarantor financial statements indicate the continued ability to cover interest-only payments for the next 12 to 18 months at the reduced rate of interest. Updated projections that indicate below break-even performance over the next 12 months remain uncertain given that the end of the moratorium (previously extended) is a “soft” date and that tenant behaviors may not follow historical norms.

***Classification:*** The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender’s treatment due to the borrower’s diminished ability to make interest payments (even at the reduced rate) and lack of principal reduction, the uncertainty surrounding the rent moratoriums, and the reduced and tight collateral position.

***Nonaccrual Treatment:*** The lender maintained the loan on an accrual basis because the borrower demonstrated an ability to make principal and interest payments and has some capacity to make payments on the interest-only terms at a below market interest rate. The examiner did not concur with this treatment as the loan was not restructured on reasonable repayment terms, the borrower has insufficient cash flow to amortize the debt, and the slim collateral margin indicates that full repayment of principal and interest may be in doubt. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

***TDR Treatment:*** The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties* as evidenced by the reported reduced, stressed cash flow that prompted the borrower’s request for payment relief in the restructure. The lender granted a *concession* (interest-only at a below market interest rate) in response. The examiner concurred with the lender’s TDR treatment.

**SCENARIO 3:** At maturity, the lender renewed the \$5.9 million loan balance on a 12-month interest-only basis at a below market interest rate. The borrower has been sporadically delinquent on prior principal and interest payments. A review of the current rent roll indicates

that 10 of the 25 units are vacant after tenant evictions. The vacated units were previously in an advanced state of disrepair, and the borrower and guarantors have exhausted their liquidity after repairing the units. The repaired units are expected to be rented at a lower rental rate. A post-renovation appraisal values the property at \$5.5 million (107 percent LTV). Updated projections indicate the borrower will be below break-even performance for the next 12 months.

**Classification:** The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender's concerns due to the borrower's diminished ability to make principal or interest payments, the guarantor's limited ability to support the loan, and insufficient collateral protection. However, the examiner classified \$900,000 loss (\$5.9 million loan balance less \$5 million (based on the current appraisal of \$5.5 million less estimated cost to sell of 10 percent, or \$500,000)). The examiner classified the remaining \$5 million balance substandard. This classification treatment recognizes the collateral dependency.

**Nonaccrual Treatment:** The lender maintained the loan on accrual basis because the borrower demonstrated a previous ability to make principal and interest payments. The examiner did not concur with the lender's treatment as the loan was not restructured on reasonable repayment terms, the borrower has insufficient cash flow to service the debt at a below market interest rate on an interest-only basis, and the impairment of value indicates that full repayment of principal and interest is in doubt. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

**TDR Treatment:** The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties* as evidenced by sporadic delinquencies, fully dissipated liquidity, and reduced collateral protection. The lender granted a *concession* with the interest-only terms at a below market interest rate. The examiner

concurred with the lender's TDR treatment.

## Appendix 2

### Selected Rules, Supervisory Guidance, and Authoritative Accounting Guidance

#### Rules

- Board regulations on real estate lending standards and the *Interagency Guidelines for Real Estate Lending Policies*: 12 CFR part 208, subpart E and appendix C.
- Board regulations on the *Interagency Guidelines Establishing Standards for Safety and Soundness*: 12 CFR part 208 appendix D-1.
- Board appraisal regulations: 12 CFR part 208, subpart E and 12 CFR part 225.

#### Supervisory Guidance

- *FFIEC Instructions for Preparation of Consolidated Reports of Condition and Income* (FFIEC 031, FFIEC 041, and FFIEC 051 Instructions).
- *Interagency Policy Statement on Allowances for Credit Losses*, issued May 2020, as applicable.
- *Interagency Guidance on Credit Risk Review Systems*, issued May 2020.
- *Interagency Supervisory Examiner Guidance for Institutions Affected by a Major Disaster*, issued December 2017.
- Board, FDIC, and OCC joint guidance entitled *Statement on Prudent Risk Management for Commercial Real Estate Lending*, issued December 2015.
- *Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings*, issued October 2013.
- *Interagency Appraisal and Evaluation Guidelines*, issued October 2010.
- Board, FDIC, and OCC joint guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, issued December 2006.
- *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, issued December 2006, as applicable.
- *Interagency FAQs on Residential Tract Development Lending*, issued September

2005.

- *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*, issued July 2001, as applicable.

#### **Authoritative Accounting Standards<sup>29</sup>**

- *ASC Topic 310, Receivables*
- *ASC Subtopic 310-40, Receivables - Troubled Debt Restructurings by Creditors*
- *ASC Topic 326, Financial Instruments – Credit losses*
- *ASC Subtopic 450-20, Contingencies - Loss Contingencies*
- *ASC Topic 820, Fair Value Measurement*
- *ASC Subtopic 825-10, Financial Instruments – Overall*

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<sup>29</sup> ASC Topic 326, *Financial Instruments - Credit Losses*, when adopted by a financial institution, replaces the incurred loss methodology included in ASC Subtopic 310-10, *Receivables - Overall* and ASC Subtopic 450-20, *Contingencies – Loss Contingencies*, for financial assets measured at amortized cost, net investments in leases, and certain off balance-sheet credit exposures.” ASC Topic 326 also, when adopted by a financial institution, supersedes ASC Subtopic 310-40 *Troubled Debt Restructurings by Creditors*.

## Appendix 3

### Valuation Concepts for Income Producing Real Estate

Several conceptual issues arise during the process of reviewing a real estate loan and in using the net present value approach of collateral valuation. The following discussion sets forth the meaning and use of those key concepts.

**The Discount Rate and the Net Present Value Approach:** The discount rate used in the net present value approach to convert future net cash flows of income-producing real estate into present market value terms is the rate of return that market participants require for the specific type of real estate investment. The discount rate will vary over time with changes in overall interest rates and in the risk associated with the physical and financial characteristics of the property. The riskiness of the property depends both on the type of real estate in question and on local market conditions.

**The Direct Capitalization (“Cap” Rate) Technique:** Many market participants and analysts use the “cap” rate technique to relate the value of a property to the net operating income it generates. In many applications, a “cap” rate is used as a short cut for computing the discounted value of a property’s income streams.

The direct income capitalization method calculates the value of a property by dividing an estimate of its “stabilized” annual income by a factor called a “cap” rate. Stabilized annual income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today’s actual market conditions. The “cap” rate, usually defined for each property type in a market area, is viewed by some analysts as the required rate of return stated in terms of current income. The “cap” rate can be considered a direct observation of the required earnings-to-price ratio in current income terms. The “cap” rate also can be viewed as the number of cents per dollar of today’s purchase price investors would require annually over the life of the property to achieve their required rate of return.

The “cap” rate method is an appropriate valuation technique if the net operating income to which it is applied is representative of all future income streams or if net operating income and the property’s selling price are expected to increase at a fixed rate. The use of this technique assumes that either the stabilized annual income or the “cap” rate used accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, the net present value approach and the direct capitalization technique will yield the same results.

The direct capitalization technique is not an appropriate valuation technique for troubled real estate since income generated by the property is not at normal or stabilized levels. In evaluating troubled real estate, ordinary discounting typically is used for the period before the project reaches its full income potential. A “terminal cap rate” is then utilized to estimate the value of the property (its reversion or sales price) at the end of that period.

**Differences between Discount and Cap Rates:** When used for estimating real estate market values, discount and “cap” rates should reflect the current market requirements for rates of return on properties of a given type. The discount rate is the required rate of return including the expected increases in future prices and is applied to income streams reflecting inflation. In contrast, the “cap” rate is used in conjunction with a stabilized net operating income figure. The fact that discount rates for real estate are typically higher than “cap” rates reflects the principal difference in the treatment of expected increases in net operating income and/or property values.

Other factors affecting the “cap” rate (but not the discount rate) include the useful life of the property and financing arrangements. The useful life of the property being evaluated affects the magnitude of the “cap” rate because the income generated by a property, in addition to providing the required return on investment, has to be sufficient to compensate the investor for the depreciation of the property over its useful life. The longer the useful life, the



smaller is the depreciation in any one year, hence, the smaller is the annual income required by the investor, and the lower is the “cap” rate. Differences in terms and the extent of debt financing and the related costs are also taken into account.

**Selecting Discount and Cap Rates:** The choice of the appropriate values for discount and “cap” rates is a key aspect of income analysis. In markets marked by both a lack of transactions and highly speculative or unusually pessimistic attitudes, analysts consider historical required returns on the type of property in question. Where market information is available to determine current required yields, analysts carefully analyze sales prices for differences in financing, special rental arrangements, tenant improvements, property location, and building characteristics. In most local markets, the estimates of discount and “cap” rates used in an income analysis generally should fall within a fairly narrow range for comparable properties.

**Holding Period versus Marketing Period:** When the net present value approach is applied to troubled properties, the chosen time frame should reflect the period over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income). That time period is sometimes referred to as the “holding period.” The longer the period is before stabilization, the smaller the reversion value will be within the total value estimate. The marketing period is the length of time that may be required to sell the property in an open market.

## Appendix 4

### Special Mention and Adverse Classification Definitions<sup>30</sup>

The Board uses the following definitions for assets adversely classified for supervisory purposes as well as those assets listed as special mention:

#### Special Mention

A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

#### Adverse Classifications

**Substandard Assets:** A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful Assets:** An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

**Loss Assets:** Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or

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<sup>30</sup> The Board's loan classification definitions of Substandard, Doubtful, and Loss may be found in the Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions Attachment 1—Classification Definitions (SR Letter 13-18). The Board's definition of Special Mention may be found in the Interagency Statement on the Supervisory Definition of Special Mention Assets (June 10, 1993).

desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

## Appendix 5

### Accounting – Current Expected Credit Losses Methodology (CECL)

This appendix addresses the relevant accounting and regulatory guidance for financial institutions that have adopted Accounting Standards Update (ASU) 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* and its subsequent amendments (collectively, ASC Topic 326) in determining the allowance for credit losses (ACL). Additional guidance for the financial institution’s estimate of the ACL and for examiners’ responsibilities to evaluate these estimates is presented in the *Interagency Policy Statement on Allowances for Credit Losses (June 2020)*. Additional information related to identifying and disclosing modifications for regulatory reporting under ASC Topic 326 is located in the FFIEC Call Report.

Expected credit losses on loans under ASC Topic 326 are estimated under the same CECL methodology as all other loans in the portfolio. Loans, including loans modified in a restructuring, should be evaluated on a collective basis unless they do not share similar risk characteristics with other loans. Changes in credit risk, borrower circumstances, recognition of charge-offs, or cash collections that have been fully applied to principal, often require reevaluation to determine if the modified loan should be included in a different pool of assets with similar risks for measuring expected credit losses.

Although ASC Topic 326 allows a financial institution to use any appropriate loss estimation method to estimate the ACL, there are some circumstances when specific measurement methods are required. If a financial asset is collateral dependent,<sup>31</sup> the ACL is estimated using the fair value of the collateral. For a collateral-dependent loan, regulatory

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<sup>31</sup> The repayment of a collateral-dependent loan is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity’s assessment as of the reporting date. Refer to the glossary entry in the Call Report instructions for “Allowance for Credit Losses – Collateral-Dependent Financial Assets.”

reporting requires that if the amortized cost of the loan exceeds the fair value<sup>32</sup> of the collateral (less costs to sell if the costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, as applicable), this excess is included in the amount of expected credit losses when estimating the ACL. However, some or all of this difference may represent a Loss for classification purposes that should be charged off against the ACL in a timely manner.

Financial institutions also should consider the need to recognize an allowance for expected credit losses on off-balance sheet credit exposures, such as loan commitments, in other liabilities consistent with ASC Topic 326.

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<sup>32</sup> The fair value of collateral should be measured in accordance with FASB ASC Topic 820, *Fair Value Measurement*. For impairment analysis purposes, the fair value of collateral should reflect the current condition of the property, not the potential value of the collateral at some future date.

## Appendix 6

### Accounting – Incurred Loss Methodology

This Appendix addresses the relevant accounting and regulatory guidance for financial institutions using the incurred loss methodology to estimate the allowance for loan and lease losses under ASC Subtopics 310-10, *Receivables - Overall* and 450-20, *Contingencies – Loss Contingencies* and have not adopted Accounting Standards Update (ASU) 2016-13, *Financial Instruments – Credit Losses (Topic 326)*.

#### ***Restructured Loans***

The restructuring of a loan or other debt instrument should be undertaken in ways that improve the likelihood that the maximum credit repayment will be achieved under the modified terms in accordance with a reasonable repayment schedule. A financial institution should evaluate each restructured loan to determine whether the loan should be reported as a TDR. For reporting purposes, a restructured loan is considered a TDR when the financial institution, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower in modifying or renewing a loan that the financial institution would not otherwise consider. To make this determination, the financial institution assesses whether (a) the borrower is *experiencing financial difficulties* and (b) the financial institution has granted a *concession*.<sup>33</sup>

The determination of whether a restructured loan is a TDR requires consideration of all relevant facts and circumstances surrounding the modification. No single factor, by itself, is determinative of whether a restructuring is a TDR. An overall general decline in the economy or some deterioration in a borrower's financial condition does not automatically mean that the borrower is *experiencing financial difficulties*. Accordingly, financial institutions and examiners should use judgment in evaluating whether a modification is a

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<sup>33</sup> Refer to ASC Subtopic 310-40, *Receivables – Troubled Debt Restructurings by Creditors*. Refer also to the FFIEC Call Report.

TDR.

***Allowance for Loan and Lease Losses (ALLL)***

Guidance for the financial institution's estimate of loan losses and examiners' responsibilities to evaluate these estimates is presented in *Interagency Policy Statement on the Allowance for Loan and Lease Losses (December 2006)* and *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (July 2001)*.

Financial institutions are required to estimate credit losses based on a loan-by-loan assessment for certain loans and on a group basis for the remaining loans in the held-for-investment loan portfolio. All loans that are reported as TDRs are considered impaired and are typically evaluated on an individual loan basis in accordance with ASC Subtopics 310-40, and 310-10. Generally, if an individually assessed loan<sup>34</sup> is impaired, but is not collateral dependent, management allocates in the ALLL for the amount of the recorded investment in the loan that exceeds the present value of expected future cash flows, discounted at the original loan's effective interest rate.

For an individually evaluated impaired collateral dependent loan,<sup>35</sup> regulatory reporting requires the amount of the recorded investment in the loan that exceeds the fair value of the collateral<sup>36</sup> (less costs to sell)<sup>37</sup> if the costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, as applicable), to be charged off to the ALLL in a timely manner.

Financial institutions also should consider the need to recognize an allowance for

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<sup>34</sup> The recorded investment in the loan for accounting purposes may differ from the loan balance as described elsewhere in this statement. The recorded investment in the loan for accounting purposes is the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest.

<sup>35</sup> Under ASC Subtopic 310-10, a loan is collateral dependent when the loan for which repayment is expected to be provided solely by the underlying collateral. Refer to the glossary entry in the Call Report instructions for "Allowance for Credit Losses – Collateral-Dependent Financial Assets."

<sup>36</sup> The fair value of collateral should be measured in accordance with FASB ASC Topic 820, *Fair Value Measurement*. For impairment analysis purposes, the fair value of collateral should reflect the current condition of the property, not the potential value of the collateral at some future date.

<sup>37</sup> See footnote 24.

estimated credit losses on off-balance sheet credit exposures, such as loan commitments in other liabilities consistent with ASC Subtopic 825-10, *Financial Instruments – Overall*. For additional information, refer to the FFIEC Call Report instructions pertaining to regulatory reporting.

For performing CRE loans, supervisory policies do not require automatic increases in the ALLL solely because the value of the collateral has declined to an amount that is less than the recorded investment in the loan. However, declines in collateral values should be considered when applying qualitative factors to calculate loss rates for affected groups of loans when estimating loan losses under ASC Subtopic 450-20.

By order of the Board of Governors of the Federal Reserve System.

**Ann E. Misback,**  
*Secretary of the Board.*

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